



I hereby certify that this correspondence is being filed by United States Postal Service as first class mail in an envelope with sufficient postage and addressed to the Commissioner of Patents and Trademarks, Washington, D.C. 20231 on the date indicated below.

Signed:

Peter K. Trzyna (Reg. No. 32,401)

Date:

August 28, 2001

PATENT

PAPER NO.

FILE NO. NewMrktP98-1

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Technology Center 2100

IN THE UNITED STATES PATENT AND TRADEMARK OFFICE

Inventors	:	Anthony F. Herbst and Wayne F. Perg
Serial No.	:	09/197,908
Filed	:	November 23, 1998
For	:	DIGITAL COMPUTER SYSTEM AND METHODS FOR MANAGING AN AUCTION MARKET FOR PREFERRED-RETURN SECURITIES
Group Art Unit	:	2761
Examiner	:	Retta Yehdega

The Commissioner of Patents
and Trademarks
Washington, D.C. 20231

DECLARATION OF PHILIP A. HORVATH

SIR:

I, Philip A. Horvath, the undersigned, being first warned that willful false statements and the like are punishable by fine or imprisonment, or both (18 U.S.C. 1001) and may jeopardize the validity of the application or any patent issuing thereon, hereby declare that all statements made herein of my own knowledge are true, and that all statements made on information and belief are believed by me to be true and:

1. I have personal knowledge of the subject matter of this affidavit, have read the above-referenced patent application, and if called as a witness, would testify thereto.

2. I am doing this declaration for no compensation of any kind, and I have no ownership interest or other in the patent application.

3. I believe that I am qualified to comment on how a person of ordinary skill in the art would understand this patent application and how to make and use the invention because my background in the field of the above-referenced patent application is evidenced by:

A. My education, which includes:

Doctor of Business Administration (D.B.A.) 1975; Major: Finance; Minor: Administrative Science; Kent State University, Kent, Ohio.

M.S., Business Administration, 1971, Indiana University at South Bend.

B.S., Business Administration, 1970, Indiana University at South Bend.

B. My employment experience, which includes:

Department of Finance and Quantitative Methods; Bradley University, Professor of Finance; Chairman, Department of Finance and Quantitative Methods, (1995-Present).

Indiana University at South Bend; 1973 to 1977, Instructor and Assistant Professor.

Kent State University: Research Assistant; 1971 to 1973.

Kroehler Manufacturing Co., Inc., Naperville, Illinois: Data Processing positions to Operations Manager; 1967 to 1969.

United States Air Force; Non Commissioned Officer (Air Police), 1959 - 1965.

And my other work-related experience, which includes:

Coordinator, Center for Business and Economic Research Colloquium Series, (1990 – present).

Director of Center for Business and Economic Research, College of Business, Bradley University 1980-82.

C. My professional memberships, which include:

American Finance Association,
Eastern Finance Association,
Western Finance Association,
Financial Management Association,
Southern Finance Association,
Southwest Finance Association, and
Beta Gamma Sigma.

D. My research, which includes, or has resulted in, numerous

presentations at professional meetings and scholarly gatherings; publications in proceedings, including: principal Investigator on several grant projects including Merrill Lynch, and CEFCU-- Primary areas are Securities analysis and markets, decision models, valuation, and discounting, the research and publications being published in *The Financial Review*, *The Journal of Finance*, *Quarterly Review of Economics and Finance*, *Journal of Applied Business Research*, *Journal of Financial Engineering*, *The Journal of Forensic Economics*, *The Real Estate Appraiser and Analyst*, *Management Accounting*, more particularly as follows:

"IMPACT OF CORPORATE LAYOFF ANNOUNCEMENTS ON SHAREHOLDER WEALTH: A DUMMY VARIABLE CROSS-SECTION TIME-SERIES ANALYSIS OF A GENERALIZED SAMPLE", Southern Business And Economics Journal, Joint with P. Hatfield and G. Filbeck (U. Toledo, Ohio). Forthcoming - Summer 2000.

"INDUSTRIAL BUYING AND THE DIVERGENCE OF CAPITAL BUDGETING THEORY AND PRACTICE: AN EXPLORATION", The Journal of Applied Business Research, Volume 15, No. 1, (Winter, 1998-1999). Joint with P.Hatfield and D.Hill.

"IMPROPRIETY AND IMMEASURABILITY OF THE(I-G) DIFFERENTIAL FOR DISCOUNTING FUTURE EARNINGS: A CRITIQUE OF LINKE AND THE PROFESSION", Missouri Valley Economic Association 35th Annual Meeting, Joint with Ed. Sattler. Feb 26, 1999, Memphis, Tenn.

"THE DETERMINATION OF DISCOUNT RATES FOR LOST WAGES: A FISHER/YIELD-CURVE APPROACH", Presented at Missouri Valley Economic Association Meetings, Feb 1998, Joint with Ed Sattler

"CALCULATING NET DISCOUNT RATES: IT'S TIME TO RECOGNIZE STRUCTURAL CHANGES; COMMENT AND EXTENSION," Journal of Forensic Economics, Vol 10, No. 3, (Fall 1997), pp. 327-332. Joint with E. Sattler.

"THE MCGRAW-HILL HANDBOOK OF INTEREST, YIELDS, AND RETURNS: A REVIEW", The Journal of Financial Engineering, Vol. 6 No. 1, (Mar 1997) pp. 85-88.

"FINANCIAL CRITERIA, CAPITAL BUDGETING TECHNIQUES AND RISK ANALYSIS IN MANUFACTURING FIRMS", Journal of Applied Business Research, Vol. 13, No. 1 (Winter 1996), pp. 95-104. Joint with P. Chadwell, B. Goitien, and A. Webster.

"FINANCIAL CRITERIA, CAPITAL BUDGETING TECHNIQUES AND RISK ANALYSIS IN MANUFACTURING FIRMS", Southern Finance Association Key West, Fla., Nov 20, 1996. Joint with P. Hatfield, B. Goitien, and A. Webster. NOTE: This was an early version of the same title above.

"CAPITAL BUDGETING: AN INTEGRATED MARKETING/FINANCIAL MANAGEMENT APPROACH", Southern Finance Association, Key West, Fla., Nov 20, 1996. Joint with Patty Hatfield and Donna Hill.

"COMPOUNDING/DISCOUNTING IN CONTINUOUS TIME", Quarterly Review of Economics and Finance, Vol. 35, No. 3, Fall, 1995, pp. 315-325.

"SHARE PRICE AND WEALTH EFFECTS OF CORPORATE LAYOFFS: A METHODOLOGY MODIFICATION", Presented at Eastern Finance Association meetings, April 1994. Joint with G. Filbeck and P. Chadwell.

Chairman, Session on Mergers and Acquisitions, Eastern Finance Association Annual Meeting, Boston MA., April 1994

Discussant "Empirical Tests of the Predictions of the Free Cash Flow theory of Mergers," Eastern Finance Association Annual Meeting, Boston MA, April 1994.

"FURTHER COMMENT ON N STAGE DISCOUNT MODEL", The Financial Review, Vol 28, No. 2 (May (1993).

"A DEMAND FOR LOTTO TICKETS BY RISK AVERSE INDIVIDUALS", Proceedings, Missouri Valley Economic Association, 29th Annual Meeting, Memphis, Tenn, Feb 25-27, 1993. Joint with D. Short and R. Scott.

"THE PEDAGOGY OF PROBLEM SOLVING: CONCRETE VERSUS ABSTRACT THINKING", Proceedings, Midwest Business Teaching Conference, Minneapolis, MN., April 25-26, 1991. With J. Highfill.

"INCORPORATING RISK INTO REAL ESTATE INVESTMENT ANALYSIS: A NEW VALUATION APPROACH", The Real Estate Appraiser and Analyst, Winter 1990, pp52-61. With L. Weinzimmer.

"A MEASUREMENT OF THE ERRORS IN INTRA-PERIOD COMPOUNDING AND BOND EVALUATION: A SHORT EXTENSION", The Financial Review, Vol 23, No 3, (Aug 1988).

"DISINTERMEDIATION REVISITED", The Financial Review, Vol 23, No 3, (Aug 1988).

"PEDAGOGICAL NOTE ON INTRAPERIOD COMPOUNDING/DISCOUNTING", The Financial Review, Vol 20, No 1, (Feb 1985) pp 116-118.

"AN EXPECTED UTILITY EXPLANATION OF PLUNGING AND DUMPING", The Financial Review, Vol 20, No 2, (May 1985), Joint with R.C. Scott.

Chairman (Invited) of session on skewness at Eastern Finance Association annual meeting, Newport, RI, April 1981.

"ON THE DIRECTION OF PREFERENCE FOR MOMENTS OF HIGHER ORDER THAN THE VARIANCE", Journal of Finance, Vol 35, No 4, (Sept 1980), Joint with R.C. Scott.

"STRUCTURAL STABILITY OF BETA", Proceedings, Eastern Finance Association, April 1980.

E. My teaching experience, which also includes: undergraduate courses in Liquidity Management, Financial Analysis, Investments, Portfolio Theory, Financial Theory, Financial Markets and Institutions, and Business Policy and Strategy; and occasionally conducting Quantitative Analysis (Statistics) courses. At the graduate level, teaching includes courses in Financial Analysis, Capital Budgeting (Real Options), Financial Strategy, Business Policy and Strategy (Capstone Course), more particularly as follows:

LIQUIDITY MANAGEMENT: A senior level course primarily concerned with the modelling and management of float, cash, marketable securities, accounts receivable, and current liabilities.

INVESTMENTS: A Junior level elective dealing with an introduction to the process of analyzing and selecting securities. Emphasize markets, securities, Fundamental and Technical analysis.

PORTFOLIO THEORY: A finance elective at the senior level which builds upon the investments course and proceeds through the development portfolios of securities and the management of portfolios in efficient and inefficient markets with emphases on CAPM, CCAPM, APT, etc.

FINANCIAL ANALYSIS: A senior level elective exploring the tools, techniques and processes of analyzing financial statements for a number of purposes.

FINANCIAL MARKETS AND INSTITUTIONS: A Junior level finance course which introduces domestic financial securities, institutions and markets as well as the relationships with

international financial securities, institutions and markets.

FINANCIAL THEORY AND POLICY: An MBA course emphasizing the theoretical underpinnings of corporate financial decisions and financial policy determination.

FINANCIAL ANALYSIS: An MBA finance concentration elective exploring advanced tools, techniques and processes of analyzing financial statements for a number of purposes.

And the following courses on an occasional basis:

FINANCIAL STRATEGY - An MBA finance elective. This course deals with the strategy implications of financial decisions, the development of financials strategy and the relationship to firm value in an asset pricing model world.

BUSINESS POLICY AND STRATEGY FORMULATION - MBA capstone course which incorporates policy and strategy considerations for management in conjunction with an international business simulation.

And seminars:

Conducted One day Seminar on *Financial Analysis* as part of three day seminar series: Accounting and Finance for the Non-Financial Manager. Feb 1999. The eighth of an annual series.

Conducted a one day seminar/discussion for CEFCU Board of Directors and Strategic Planning Group. Oct 30, 1998.

MANAGEMENT FOR THE 90'S, A four week, two day per week, seminar for Caterpillar Tractor Company ...Financial Management Module. Feb-Mar 1996. The ninth of a series.

ENHANCING BUSINESS VALUE THROUGH FINANCIAL PLANNING. A one day seminar for non-financial managers on planning. April 1997. The fifth of an annual series.

Conducted two evening seminars on investment basics to CEFCU employees at CEFCU Central Office - August 19 & 20, 1997. Addressed approximately two-thirds of CEFCU Employees.

Numerous other occasional 1/2 day and multiple day seminars to professionals on various financial topics, including: regularly conducting full day seminars in financial management for non-financial managers, financial planning for non-financial managers; conducting intensive, extensive seminars for Caterpillar, Inc., managers; conducting intensive programs in financial management for managers at local firms such as Fleming-Potter, CEFCU, and others.

F. My investigator experience, which includes:

Principal Investigator, Bradley University Office of Sponsored Research Grant - 1999 (renewal) Data gathering and analysis costs for study of extension of market differences between commercial banks and non-bank commercial lenders.

Principal Investigator, Bradley University Office of Sponsored Research Grant -1998. Data gathering costs for study of extension of market differences between commercial banks and non-bank commercial lenders.

Principal Investigator, CEFCU Impact Study. Sponsored by CEFCU to determine what impact, if any, a strong and aggressive credit union has on the costs and returns of the general community in its market. November 1996 - September, 1997.

Principal Investigator, Bradley University Office of Sponsored Research Grant - 1995. Develop, mail and analyze survey data regarding capital budgeting practices in industry.

G. My business experience, including creating, designing and co-founding NIPHIX Systems, Inc., a trading system (now classified as ATS/ECN) specifically designed for IPOs of Reg A, and SB1 registered securities and secondary trading of NASD Bulletin Board and Pink Sheet type companies for traders who are accredited investors; continuing as member of the board and consultant; co-founding of, and consultant to, NIPHIX Investments, Inc., a NASD/SIPC member broker/Dealer firm, and; NIPHIX Advisors, a SEC registered investment advisory firm; Continue as Portfolio designer (Asset Allocation) for NIPHIX Advisors; extensively involvement in small business consulting both independently and through the Bradley University Small Business Development Center; have held posts as officer and board member of a number of for-profit and not-for-profit organizations and foundations; and consulting Expert and expert witness for various law firms in the areas of: securities, risk assessment, valuation, and financial impact.

4. Based on the foregoing, I have an extensive background in the field of the above-referenced patent application, and this background includes an extensive exposure to those skilled in the art of the patent application as of the time that the patent application was filed; I therefore am qualified to comment on the meaning of the disclosure in the patent application to such individuals.

5. Based on my experience, I believe that the term "preferred return instrument" would not be understood as the Patent Examiner proposes, which appears to be an attempt to interpret these words as a legal term or as a compound noun; but would instead have been understood as 3 words with separate, plain, and ordinary English meanings. Anyone with a dictionary could understand the meaning of these words.

6. Generally, the meaning of the words "preferred return instrument," would have been understood as follows: "preferred" means preferable or better, but in the past tense. "Return" means yield or profit. "Instrument" means a formal legal document, such as a stock or bond. Thus, a preferred return instrument means a formal legal document (such as a bond or stock) that has a yield or profit better than another, for example preferred stock offers a preference over other classes of stock. Simply put, the "preferred return" refers to the return that is preferred by each individual/institution involved in the bid and ask process for an instrument.

7. As to the term "preferred return," the Patent Office received many examples of the use of this term, such as in the securities regulations, but I see the Patent Office mistakes an example (preferred stock) of the common understanding of the term as a definition of the term. Again, this seems to be a problem of stringing together the words, instead of looking at the dictionary definitions of each word to find the meaning of the combination of words. It is clearly incorrect for the Patent Office to interpret the term "preferred return instrument" as limited to "preferred stock" because stock is only one example of "instruments." A preferred return instrument can be any instrument with a return and / or claim on assets preferred to the claim of the owner(s) of the business and /or asset, including debt or equity instruments of all types and even financings like leases and limited partnership agreements.

8. As to the term "financial instruments," I believe that it is essentially not possible for a person to complete an undergraduate degree in business without encountering this terminology. I see that the Patent Office has already been informed that the term is used in SEC laws and that there is a FASB directly on the subject. The notion of a financial instrument is clearly understood in the financial industry.

9. After spending a few hours reading the application I can readily comment on how one would have been able to make and use this invention. The patent application recognizes that an issuer provides necessary identifying and characteristics of an instrument, including the face value and intermediate cash flow stream as well as the preferred return. This return is clearly the return that is preferred, but not promised, by the issuer which when used to discount the cash flow stream and face value as to time would result in a price using standard, common net present value.

10. Elsewhere, the patent application recognizes that primary market buyers as well as secondary market buyers and sellers provide their preferred return for that instrument. In further descriptions, one would easily understand that these are used to construct a supply curve consisting of the quantity of units offered/desired at each given price/preferred return provided by all sellers who have offered their units up for sale. Similarly the demand curve is determined by the number of units sought by buyers at their preferred price/return. Forming supply curves from issuer or market information and demand curves from buyers' demands are matters encountered in other matching systems, and the programming an implementation with preferred return instruments would not be complex.

11. At various times, I have written computer programs in a number of

programming languages and including fortran, algol, cobol, visual basic and others, and developed relevant computer systems. I am also a co-founder and designer of an automated trading system referenced above.

12. Making and using such a system set out in the patent application is not rocket science, and would most efficiently be implemented as an add-on to an existing system.

13. In the implementation, as to the terminology "sufficient financial characteristics for computing a price for preferred return instrument," people of ordinary skill would readily have known how to price a preferred return instrument because such pricing is done on a large scale basis for these kinds of instruments, as suggested in the patent application. Pricing these financial products poses no obstacle to making this system because the same techniques used on a large quantity would be used for a smaller quantity, i.e., by using (1) the rate of return and (2) the payment amounts and times corresponding to the instrument, or a data set that can be used to calculate the same.

14. I believe that someone facile in programming would have found implementing this invention to be very do-able without any expected uncertainty or need for experimentation. I foresee no challenge or any obstacle beyond tedium.

Date:


Philip A. Horvath, D.B.A.



I hereby certify that this correspondence is being filed by United States Postal Service as first class mail in an envelope with sufficient postage and addressed to the Commissioner of Patents and Trademarks, Washington, D.C. 20231 on the date indicated below.

Signed:

Peter K. Trzyna (Reg. No. 32,801)

Date:

August 28, 2001

PATENT

PAPER NO.

FILE NO. NewMrktP98-1

IN THE UNITED STATES PATENT AND TRADEMARK OFFICE

Inventors	:	Anthony F. Herbst and Wayne F. Perg
Serial No.	:	09/197,908
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For	:	DIGITAL COMPUTER SYSTEM AND METHODS FOR MANAGING AN AUCTION MARKET FOR PREFERRED-RETURN SECURITIES
Group Art Unit	:	2761
Examiner	:	Retta Yehdega

The Commissioner of Patents
and Trademarks
Washington, D.C. 20231

DECLARATION OF NIMISH GANDHI

SIR:

I, Nimish Gandhi, being first warned that willful false statements and the like are punishable by fine or imprisonment, or both (18 U.S.C. 1001) and may jeopardize the validity of the application or any patent issuing thereon, hereby declare that all statements made herein of my own knowledge are true, and that all statements made on information and belief are believed by me to be true and:

1. I have personal knowledge of the subject matter of this affidavit, have read the above-referenced patent application, and if called as a witness, would testify thereto.
2. I am doing this declaration for no compensation of any kind, and I

have no ownership interest or other in the patent application.

3. I am the President of Niphix, an Alternative Trading System providing the essence of stock exchange, in Peoria, Illinois, and have been since I co-founded it in October 1993, and this and my other experience and education listed below has given me familiarity with what was known by people having ordinary skill in this art at the time this patent application was filed.

4. Niphix is a "financial marketplace" particularly focused on small businesses. I have been responsible for supervising development of Niphix software to assist customers in the Alternative Trading System exchange activities. I am also responsible for the entire operation including human resources, marketing and financial management, as well as in the development and implementation of legal and business strategies. From inception to December 1996, I have been responsible for developing the Niphix exchange concept and obtaining permission from the SEC to operate this marketplace, as well as developing a large customer base before the operations commerce.

5. From 1/1990 to 6/1995, I was an Assistant Professor, Department of Marketing, at Bradley University, Peoria, Illinois. I served as a teacher, researcher, author, consultant. In charge of developing and teaching various marketing courses at the graduate and undergraduate levels. I introduced two new courses, one in marketing information systems (undergraduate) and, another in marketing planning (for marketing executives). I was also responsible for teaching marketing strategy in executive development seminars, conducting research on unexplained phenomena and extended the boundaries of knowledge in advertising, services, and information systems areas. I published 13 papers in 3 years and, wrote 6 others in different stages, on different topics including expert systems. I was appointed as the Caterpillar Fellow for 1992-1993, and I served as the Chairman of Marketing Department in 1993. Additionally, I provided

consulting services to small business organizations on market analysis, marketing planning, and promotional campaigns.

6. From 7/1985 to 6/1990, I was a Visiting Assistant Professor, Department of Marketing at Virginia Polytechnic Institute and State University, Blacksburg, Virginia. My responsibilities included developing and teaching various undergraduate courses including, marketing research, consumer behavior, and international marketing. I also conducted several research projects independently as well as with other faculty members in advertising and buyer behavior areas.

7. From 8/1984 to 5/1985, I was an Adjunct Faculty Member, Department of Business, Southern Indiana University, Evansville, Indiana. My responsibilities included teaching courses in marketing research and, product and pricing management.

8. I have an education that includes a Ph.D. in Business, Virginia Polytechnic Institute and State University, May 1990; an M.B.A. Indiana University, May, 1984; a B.S. Business, University of Wisconsin, December 1981; and a B.S., University of Bombay, Physics with a Mathematics Minor, May 1977.

9. I have reviewed the patent information regarding Messrs. Herbst and Perg's invention related to preferred return instruments applied with a computerized system.

10. Overall, the invention is quite simple to implement and in my opinion, therefore elegant.

11. Preferred return instruments are common in the financial industry, and what they are would have been understood by essentially anyone with a background in finance, who would also know that many companies have historically and frequently used preferred return instruments to finance their businesses.

12. Preferred return instruments can include debt or equity. Most common are preferred return equity instruments, i.e., preferred stocks. With preferred return instruments, investors have an incentive to supply capital to a company because their position with reference to common equity holders is more protected. As such, with preferred return instruments, companies offer certain rate of return to investors with an eye toward eventually retiring or restructuring the investment in future. Projects with fairly accurate estimates of cash flow are typically financed by preferred return instruments, as the cost of capital to the company is known in offering preferred return investments opportunities.

13. Preferred return instruments contain a finite rate of return with which the investment grows for investors. For instance, currently the range for preferred returns is about 8 and 12 percent annually. Such instruments have a maturing date, that is, there is a time limit on how long the company plans to utilize investors funds and return with the funds at the end of the period. Preferred stocks enable investors to lay their claims on the company ahead of common stock holders, hence the term preferred.

14. What Messrs. Herbst and Perg are proposing is a much-needed enhancement to the traditional view of preferred return instruments. With this development, potential investors as well as businesses will have an opportunity to optimize preferred return instruments. Companies will be able to offer a range of preferred returns to potential investors and conversely, potential investors can counter offer a range of acceptable returns. This will allow a market of preferred return instruments to develop whereby preferred returns can be auctioned off and the going price will be the most optimal price for everyone involved.

15. Although preferred return instruments are common, there is no organized simple approach to trade them. Preferred return instrument holders generally rely upon the issuing companies to repay them with investment and interest. However, if

there were to exist a systematic approach so investors can liquidate such instrument, I believe that there would be a widespread appeal for such a service.

16. The approach devised by Messrs. Herbst and Perg is rather mechanistic for a software programmer to develop a software routine to enable trading preferred instruments with ease. For example, if the Niphix Alternative Trading System, of which I am president, were to implement the system using the Niphix Trading System, it would be a rather easy simple addition to our system.

17. Niphix operates a "matching" software to enable buyers and sellers of high risk investment instruments. These instruments can be debt or equity and can include common stock or preferred stock as well as bonds, etc. The Niphix trading system currently allows potential buyers and sellers to negotiate the buy and sell price and thus receive the best / optimum price themselves. Currently, Niphix trading system accommodates common stocks. However, this trading system can be easily modified to accommodate preferred return instruments. Such trading systems are relatively easy to develop in that there exists several models to develop such systems on.

18. There also exists other auction systems also (e.g., WASI, POSIT) which permit auctions of equity and debt instruments. While auction systems are not uncommon, there does not seem to be an auction system for preferred return instruments.

19. Additionally, the market for preferred return instruments traditionally has been directed at large companies on one side and large investors on the other side. This has facilitated evolution of trading of preferred return instruments in large volumes where each trade is high number as well as high value. Although there is no market system for small number and small value of preferred return instruments, which can be addressed by the system proposed by Messrs. Herbst and Perg, the

operational ideas such as pricing and instrument characteristics do not change by virtue of the smaller quantity being handled. One with ordinary skill would have known this.

20. Trading of preferred return instruments entails a range of acceptable cost of capital to the issuing companies (i.e., seekers / buyers of funds) and a range of acceptable returns to potential investors (i.e., suppliers / sellers of funds). Buyers of funds, offering preferred return instruments have a demand curve which helps them determine the price at which they would receive the funds. On the other hand, sellers of funds, investing in such instruments have a supply curve that allows them to evaluate the risk return relationship in order to provide funds to the companies. Indeed, each company may have one demand curve for the preferred return instrument for a finite amount for funds. Whereas, with a number of potential suppliers of funds, there may be multiple supply curves possible. Thus, there may be various points of intersection of the demand and supply curves. An auction system, the likes of which existed for other products, would allow the buyers and sellers of funds to agree to exchange funds at different prices, allowing the companies to raise the funds at different cost of capital with different investors, however remaining within the acceptable level of cost of capital. Overall, such a system would permit customization of preferred return instruments to both the buyers and sellers of funds.

21. Thus, what Messrs. Herbst and Perg have proposed is an advancement that can be easily put to practice by supplementing existing systems to focus upon preferred return instruments. For example, in the case of the Niphix trading system, implementation would most efficiently involve replicating some computer screens of our existing system, changed a bit to accommodate preferred return instruments, and using other existing functionality and other known components, tweaked here and there, to have a system running in no more than one man week.

22. I can imagine no need for any experimentation except the usual debugging and operational testing needed for any computer program.

Date: 8-27-01

Nimish Gandhi
Nimish Gandhi, Ph.D.

5018 Ancient Oak Drive
Peoria, Illinois

Filed March 9, 1998

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 97-1170

HENKELS & MCCOY, INC.

v.

ROBERT ADOCHIO, RALPH ANDERSON, ROBERT
BADER, RALPH BARUCH, JOHN BUCK, ALAN
GOLDBERG, FRED GREEN, LEONARD C. GREEN,
C. BRUCE JOHNSTONE, HERBERT KAUFER, BILL
LUCAS, WILLIAM MILLER, ARTHUR ROTHLEIN, EDWARD
ROWAN, JOSEPH SCUTELLARO, CONRAD STRUDLER,
BARRY WAGENBERG, ARTHUR WELLMAN, JAMES R.
WILLING, and CHESTER DAVIS

Ralph Anderson, Robert Bader, Ralph Baruch, John Buck,
Fred Green, Leonard C. Green, C. Bruce Johnstone,
Herbert Kaufer, Bill Lucas, Arthur Rothlein, Edward
Rowan, Joseph Scutellaro, Barry Wagenberg, Arthur
Wellman, James R. Willing and Chester Davis,

Appellants

An Appeal from the United States District Court
for the Eastern District of Pennsylvania
D.C. No. 94-cv-03958

Argued: October 15, 1997

Before: STAPLETON, ALITO, and ROSENN, Circuit Judges.

(Opinion Filed March 9, 1998)

Robert J. Stern
Stradley, Ronon, Stevens & Young
2600 One Commerce Square
Philadelphia, PA 19103
Counsel for Appellee

Roger B. Kaplan
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OPINION OF THE COURT

ROSENN, Circuit Judge.

This appeal presents an important question pertaining to



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the obligation of limited partners to return capital contributions distributed to them in violation of their partnership agreement which required that they establish reasonably necessary reserves. The issue is rendered complex by an interrelated maze of corporations and partnerships devised by the limited partners and the general partner in their efforts to develop two separate real estate projects. One of these, Timber Knolls, was aborted shortly after conception, and the other, Chestnut Woods, became the genesis of protracted litigation and of this appeal.

The defendants-appellants are limited partners of Red Hawk North Associates, L.P. (Red Hawk) L.P., a New Jersey limited partnership. G&A Development Corporation (G&A) is the general partner of Red Hawk. Cedar Ridge Development Corporation (Cedar Ridge), a New Jersey corporation, and Red Hawk entered into a joint venture agreement, the Chestnut Woods Partnership (Chestnut), to develop, construct, and market residential homes in Bucks County, Pennsylvania. Red Hawk and Cedar Ridge are both general partners of Chestnut Woods. Under the joint venture agreement, Red Hawk would provide the funding and Cedar Ridge would provide the land which it previously

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had agreed to purchase. Cedar Ridge would act as the managing partner and general contractor.

On December 29, 1989, Cedar Ridge, as general contractor for Chestnut Woods, entered into a written subcontract with Henkels & McCoy, Inc. (Henkels), the plaintiff herein, to have it furnish the labor, materials, and equipment for the installation of the storm and sanitary sewer systems for the project. Cedar Ridge agreed to pay Henkels a fixed-price of \$300,270 under the contract. Henkels completed the installation of the storm and sewer systems but Chestnut Woods defaulted in making the payments due under the contract. Henkels, a Pennsylvania corporation, then filed three actions in the United States District Court for the Eastern District of Pennsylvania; Henkels filed the first in December 1990 against Cedar Ridge and Red Hawk, trading as Chestnut Woods, for the balance due on the contract plus interest. The court entered a default judgment which was not satisfied in whole or part.

Henkels then filed suit against G&A in its capacity as a general partner of Red Hawk and obtained a default judgment in the same amount as it had obtained against Cedar Ridge and Red Hawk. Efforts to obtain payment on this judgment also proved fruitless and counsel for the defendants advised plaintiff 's counsel by letter dated October 26, 1993 that Red Hawk was worthless. Henkels' counsel also had been advised that G&A was unable to pay the judgment out of its assets.

Henkels finally brought this suit against the nineteen limited partners of Red Hawk (the Partners), standing in the shoes of the Red Hawk limited partnership; sixteen of the partners are parties to this appeal. Henkels sought, inter alia, to compel replacement of certain capital distributions made by Red Hawk to the limited partners aggregating \$492,000 during the period that Cedar Ridge was obligated under its contract with Henkels to pay Henkels \$300,270. Henkels alleged that the capital distributions were made in violation of the Red Hawk limited partnership agreement and S 42:2A-46(b) of the New Jersey Uniform Limited Partnership Law of 1976 (New Jersey ULPL).

3

After the district court denied both Henkels's and the Partners' motions for summary judgment,¹ it conducted a bench trial and on January 6, 1997, entered judgment in favor of Henkels. The court held each limited partner of Red Hawk liable to Henkels for his proportionate share of liability in the total amount of \$371,101.84 plus interest to the date of payment of any judgment. The Partners appealed. We affirm.²

I.

The following facts are undisputed and are based upon the stipulation of the parties and the findings of fact made by the district court. The Red Hawk partnership, consisting of 20 (1 deceased)³ limited partners and one corporate general partner, G&A, was formed in 1986. Pursuant to their partnership agreement, the Partners contributed \$3.5 million in capital which ultimately they allocated to two distinct partnership projects, Timber Knolls and Chestnut Woods.

In 1987, Red Hawk and Cedar Ridge entered into a joint venture agreement forming the Chestnut Woods Partnership, with both Red Hawk and Cedar Ridge as general partners. Under the joint venture agreement, Red Hawk would provide the capital funds for the project and Cedar Ridge would provide the general management and assign its contract for the purchase of the land. Red Hawk funded the Partnership with an initial capital contribution of \$650,000 (and an additional contribution of \$200,000 in 1988). Cedar Ridge agreed to act as both the managing partner and the general contractor of the Chestnut Woods project. In addition, Cedar Ridge had the right to incur

1. Henkels & McCoy, Inc. v. Adochio, 906 F. Supp. 244 (E.D. Pa. 1995).

2. The district court had jurisdiction over this matter pursuant to 28 U.S.C. S 1332, as it is a civil action involving parties of diverse citizenship and the amount in controversy at the time the suit was filed in 1994 was in excess of the then existing \$50,000 jurisdictional amount. This Court has appellate jurisdiction of the district court's final order pursuant to 28 U.S.C. S1291.

3. Conrad Strudler, a limited partner, died before trial and was no longer a defendant.

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liabilities on behalf of the partnership in connection with the partnership's reasonable and legitimate business, borrow money in the name of the partnership, and incur reasonable and legitimate expenses related to the Chestnut Woods property. Work on the Chestnut Woods project subsequently commenced.

In 1988, Red Hawk and Cedar Ridge entered into a second and distinct joint venture agreement to form the Timber Knolls partnership, under which both Red Hawk and Cedar Ridge were also general Partners. Red Hawk contributed \$2.3 million to the Timber Knolls partnership and Cedar Ridge again agreed to act as both the managing partner and the general contractor of the project. Unlike the Chestnut Woods project, the Timber Knolls project never commenced operations. Therefore, in 1988, the Red Hawk Partners entered into an agreement with Cedar Ridge requiring the latter to return Red Hawk's \$2.3 million capital contribution. As evidence of this obligation, Cedar Ridge executed promissory notes aggregating \$2.3 million with interest and principal payable quarterly.⁴ Cedar Ridge made quarterly payments to Red Hawk on the notes, and G&A distributed these payments to the individual Red Hawk Partners, as follows:

Date	Payments by Cedar Ridge to Red Hawk On the Notes	Distributions by G&A to the Red Hawk Partners
(1) Jan. 1989	\$ 78,750	\$ 76,200
(2) April 1989	\$215,000	\$207,900
(3) July 1989	\$215,000	\$207,900
Totals	\$508,750	\$492,000

Meanwhile, on December 29, 1988, Cedar Ridge, in its role as general contractor of Chestnut Woods, bound itself to a \$300,270 fixed-price contract with Henkels, under which Henkels agreed to furnish and install storm and

4. Each note initially called for quarterly interest of \$78,750 only, with balloon payments of principal due on the third quarter of each year. In addition, the \$2.3 million due was subsequently reduced to \$2.1 million, with \$200,000 transferred to Red Hawk's stake in Chestnut Woods, thereby increasing its investment to \$850,000.

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sanitary sewer systems for the Chestnut Woods

development. The contract identified Cedar Ridge as the "General Contractor," Henkels as the "Subcontractor," and Chestnut Woods as the "Property Owner." The contract did not mention the relationship between Cedar Ridge and the Chestnut Woods Partnership, and made no reference to Red Hawk. It provided that the General Contractor, Cedar Ridge, was obligated to pay Henkels, payments to be made against billed invoices 30 days after approved inspection. At that time, Henkels was unaware that Cedar Ridge and Red Hawk were partners in Chestnut Woods.

On January 16, 1989, Henkels commenced the installation of the Chestnut Woods storm and sewer systems and completed the work according to the contract in late 1989. Under the contract, Cedar Ridge was required to pay Henkels in progress payments as invoiced. Accordingly, Henkels invoiced Cedar Ridge and received payments as follows:

Invoice Date	Invoice Amount	Invoice Status
(1) Feb. 24, 1989	\$ 37,632	paid in full 4/4/89
(2) May 24, 1989	\$ 33,421	paid in full 7/6/89
(3) Aug. 14, 1989	\$215,175	only \$25,000 paid on 10/19/89
(4) Sept. 28, 1989	\$ 37,183	no payment
(5) Nov. 9, 1989	\$ 10,586	no payment
	\$333,996	Total amount paid = \$ 96,053
		Total amount unpaid = \$237,943

Thus, Henkels received a partial payment in October on its August invoice and no payments on its September and November invoices, leaving a total unpaid balance of \$237,943. G&A, the general partner for Red Hawk, failed to establish any reserves from the cash receipts of the limited partnership.

On March 16, 1990, Cedar Ridge sold its assets to Red Hawk. Shortly thereafter, in April 1990, G&A agreed with Henkels to pay Cedar Ridge's outstanding obligations to it, including accrued interest. However, Cedar Ridge paid only two small payments aggregating \$8,000.

On December 19, 1990, Henkels sued Cedar Ridge and Red Hawk, trading as Chestnut Woods, claiming breach of

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the installation contract and the April 1990 agreement, unjust enrichment, and conspiracy to defraud. Henkels obtained judgment against Cedar Ridge and Red Hawk in the amount of \$282,421.55, including interest. Cedar Ridge and Red Hawk were unable to satisfy this judgment, in whole or in part.

In June 1992, Henkels sued G&A in its capacity as general partner of Red Hawk for the amount of the judgment previously obtained against Cedar Ridge and Red

Hawk. On August 12, 1992, the Henkels obtained a default judgment against G&A in the sum of \$282,424.55 plus interest at 6% per annum from October 15, 1991. When Henkels learned that G&A was unable to satisfy this judgment in whole or in part, it filed the instant suit seeking to have the Partners return to Red Hawk the cash capital distributions they received in 1989 as limited partners so that Red Hawk could satisfy the judgment obtained by Henkels against it.

The parties stipulated in the district court that the distributions made to the Red Hawk limited partners constituted a return of capital and that the distributions did not violate the New Jersey Limited Partnership Act. The district court concluded, however, in a careful and thorough opinion, that Paragraph 12(a) of the Red Hawk agreement of limited partnership governed the distribution of all cash receipts, except those derived from the operation of the property, and found that the payments on the promissory note from Cedar Ridge to Red Hawk did not constitute cash receipts derived from operations. It therefore held that the general partner was obligated to follow the mandate of Paragraph 12(a)(iv) of the partnership agreement which required the establishment of reasonable reserves prior to distributing cash receipts to the limited partners.

The district court found that the general partner in Red Hawk failed to establish any reserves and that Red Hawk had knowledge of its contingent obligations in the Chestnut Woods project and knew or should have known of the strong potential that the assets of Chestnut Woods would not cover the expenses it continued to incur for site improvements by Henkels and for which Red Hawk was

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ultimately responsible. Accordingly, it held that Red Hawk violated the partnership agreement by failing to establish reasonable reserves to cover the cost of the site improvements made by Henkels.

The court accordingly entered a verdict in favor of Henkels and against the Partners individually for their proportionate share of liability in accordance with the monetary sums set forth in its conclusions of law in the total amount of \$371,101.84 to date plus interest to the date of payment of any judgment.

The Partners appealed.

II.

On appeal, the Partners contend that the district court erred in holding that at the times of the distributions by Red Hawk to its limited partners, Henkels was a creditor of Red Hawk and that the distributions were made in violation of the partnership agreement. They also argue that even if

Henkels were a creditor of Chestnut Woods, Red Hawk, as a Chestnut Woods partner, was not jointly and severally liable for the partnership debts (as a guarantor of payment) but rather only contingently liable as a guarantor of collection, and then only in the event Henkels obtained a judgment against the Chestnut Woods Partnership and failed to collect on such judgment.

This Court reviews a district court's construction and application of the New Jersey Uniform Limited Partnership Law de novo. See *Salve Regina College v. Russell*, 499 U.S. 225, 231 (1991); *Schreiber v. Kellogg*, 50 F.3d 264, 266 (3d Cir. 1995). However, whether Red Hawk and G&A breached the Red Hawk limited partnership agreement by failing to establish reasonably necessary reserves, and thus the Partners ultimately received the distributions in violation of the agreement, is a mixed question of law and fact. Accordingly, this Court exercises plenary review of the legal operation of the partnership agreement, but will vacate the district court's contract interpretations and subsidiary factual findings only if they are clearly erroneous. See *Cooper Lab., Inc. v. International Surplus Lines Ins. Co.*, 802 F.2d 667, 671 (3d Cir. 1986); *Ram Constr. Co., Inc. v.*

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American States Ins. Co., 749 F.2d 1049, 1053 (3d Cir. 1984).

As a preliminary matter, we must first address the Red Hawk Partners' argument that Henkels was not a creditor who had extended credit to Red Hawk at the time of the 1989 capital distributions, and therefore the Partners were not liable to Henkels. The Partners base their argument on Section 42:2A-46(a) of New Jersey's ULPL, entitled "Liability upon return of contribution," which provides

a. If a limited partner has received the return of any part of his contribution without violation of the partnership agreement or this chapter, he is liable to the limited partnership for a period of one year thereafter for the amount of the returned contribution, but only to the extent necessary to discharge the limited partnership's liabilities to creditors who extended credit to the limited partnership during the period the contribution was held by the partnership.

N.J. Stat. Ann. § 42:2A-46(a) (emphasis added). The Partners' reliance on this section is, however, misguided for several reasons: first, and most importantly, Henkels brought suit under Section 42:2A-46(b) not (a); second, subsection (b) is not in any way dependent upon nor does it even make cross reference to subsection (a); third, subsection (b) does not require that Henkels have extended credit or have been a creditor, nor does it even mention the word "creditor." Finally, subsection (b) addresses an entirely different concern than subsection (a): contributions made in violation of a partnership agreement or the New Jersey

ULPL as opposed to distributions made without such violations but to the prejudice of creditors. Accordingly, Section 42:2A-46(a) is irrelevant to the issues raised on this appeal.

Our analysis does not end with this conclusion, however, because as just mentioned, Henkels does allege that the distributions made by G&A to the Partners were illegal under Section 42:2A-46(b) of the New Jersey ULPL. Henkels specifically alleges that the distributions violated the New Jersey ULPL because they were made in violation of the Red Hawk partnership agreement. Accordingly, we confine our

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analysis to the relevant sections of the partnership agreement in conjunction with Section 42:2A-46(b) which, in its entirety, reads as follows:

b. If a limited partner has received the return of any part of his contribution in violation of the partnership agreement or this chapter, he is liable to the limited partnership for a period of six years thereafter for the amount of the contribution wrongfully returned.

(emphasis added). Section 12(a) of the Red Hawk partnership agreement specifically provided that cash receipts be used for the establishment of reasonable reserves (for creditors) before such receipts be distributed to the Partners.⁵ The Partners contend that the distributions were not made in violation of the partnership agreement because Henkels, under the sewer subcontract, at most was a creditor of only Cedar Ridge, not of either Chestnut Woods or Red Hawk. Thus Red Hawk, they argue, was not required to establish reserves. Pursuant to this reasoning, the Partners assert that because Henkels was not a creditor, they did not receive the 1989 distributions in violation of the partnership agreement and thus did not violate the New Jersey ULPL.

The district court, however, committed no error when it found that Henkels was a creditor of Red Hawk even though Henkels was not in direct contractual privity with either Chestnut Woods or Red Hawk. The Partners contend that this was in error and that they could not be liable to Henkels because Cedar Ridge was acting solely in its capacity as general contractor and not as a partner in Chestnut Ridge when it entered into the contract with Henkels. Thus they contend that the contract did not bind Chestnut Woods or Red Hawk in any way.

5. Section 12, in pertinent part, provides that:

(a) Application of Cash Receipts. Cash receipts shall be applied in the following order of priority:

. . . .

(iv) to the establishment of such reserves as the General Partner shall reasonably deem necessary; and

(v) to distributions to the Partners . . .

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In support of their argument, the Partners note that the Subcontract Agreement with Henkels identifies Cedar Ridge as the "General Contractor," Henkels as the "Subcontractor," makes no mention of Red Hawk, and merely lists the Chestnut Woods Partnership as the "Property Owner." The contract, signed only by Henkels and Cedar Ridge, also states that Henkels shall invoice and be paid by Cedar Ridge, and provides that the Chestnut Woods property shall not serve as security for payment or be subjected to liens. The Partners also consider significant that Henkels acknowledged that the contract was with Cedar Ridge only and that Henkels had no knowledge that Cedar Ridge or Red Hawk were partners in Chestnut Woods. The Partners argue that these facts conclusively establish that Cedar Ridge entered into the contract solely in its capacity as general contractor, not as a general partner of Chestnut Woods, and therefore Cedar Ridge is solely liable under the contract.⁶

This "two hats" argument, although creative, is merely one of form over substance, ignoring the essence of the Chestnut Woods partnership agreement as well as fundamental principles of agency and partnership law which largely control the outcome of this case. First, the essence of the Chestnut Woods partnership agreement was that Red Hawk would "fund the PARTNERSHIP" by providing the capital with which to develop the property, while Cedar Ridge would contribute its development expertise by "act[ing] as the MANAGING PARTNER and GENERAL CONTRACTOR." (App. 76a, "Joint Venture Agreement, Chestnut Woods Partnership"). Thus, when Cedar Ridge signed the contract with Henkels as General Contractor, it simultaneously also was acting as a partner in the joint venture pursuant to its express authority to

6. The Partners cite in their brief, *In Re Moserbeth Assoc.*, 128 B.R. 716 (E.D. Pa. 1991), as support for this argument. Moserbeth, however, is inapposite. In Moserbeth, the general contractor was not itself a partner in the limited partnership, but instead was a separate and distinct corporation owned 100% by a partner in the partnership. This separate and distinct corporate identity was critical to the Moserbeth court holding that the partnership was not liable for the debts of the general contractor.

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"act as the . . . GENERAL CONTRACTOR" as provided in

the Chestnut Woods partnership / joint venture agreement. Second, it is elementary that "[e]very partner is an agent of the partnership for the purpose of its business, and the act of every partner . . . binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter." N.J. Stat. Ann. S 42:1-9(1); see also *Eule v. Eule Motor Sales*, 170 A.2d 241, 243 (N.J. 1961); Restatement (Second) of Agency SS 12, 140 (1958). This principle holds true even when, as here, the principal is undisclosed and the agent signs the contract in his individual capacity for the benefit of the partnership. But when a third party creditor ascertains an agency relationship, it may hold the partnership as principal liable (and ultimately the individual partners) even though the creditor was unaware of the agency relationship at the time that he extended the credit to the agent. See *Looman Realty Corp. v. Broad St. Nat'l Bank of Trenton*, 161 A.2d 247, 255-56 (N.J. 1960) ("The principal, if discovered, may also be a party to the contract."); *Levy v. Iavarone*, 154 A. 527 (N.J. 1931) (seller can recover from partner, although seller did not know at the time credit was extended to the partner's agent that a partnership relationship existed between the partner and the agent); *Yates v. Repetto*, 47 A. 632, 633 (N.J. 1900) (when credit is given to an agent, and the principal is unknown, the creditor may elect upon disclosure of the principal, to hold either the agent or the principal liable); *Moss v. Jones*, 225 A.2d 369, 371 (N.J. Super. Ct. App. Div. 1966) ("If the existence of the principal is not known until after [a judgment against the agent goes unsatisfied], then the undisclosed principal may be sued, notwithstanding the judgment against the agent."); Restatement (Second) of Agency SS 186, 190, 194, 195 (1958).

Here, it is undisputed that Red Hawk was a partner with Cedar Ridge in the Chestnut Woods Partnership, that Cedar Ridge had actual authority to enter into the contract with Henkels,⁷ that the sewer systems were being installed for

7. Paragraph 13.1(b) of the Chestnut Woods partnership agreement delegated to the managing partner, Cedar Ridge, general management

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the benefit of the Chestnut Woods Partnership, and that Cedar Ridge was entitled to reimbursement from Chestnut Woods for all monies paid by Cedar Ridge to Henkels. Accordingly, the district court committed no error when it ruled that, although indirect, a creditor relationship existed between Red Hawk and Henkels based on the contract signed by Red Hawk's partner in the Chestnut Woods Partnership, Cedar Ridge.

The Partners also argue that the district court erred in finding that Henkels was a creditor of Red Hawk, because, even assuming arguendo that a contractual relationship existed between Red Hawk and Henkels, Henkels had not

extended any credit to Cedar Ridge, Chestnut Woods, or Red Hawk. The unpaid invoices at issue here are from August, September, and November 1989, whereas the distributions to the Red Hawk Partners were made prior, in January, April, and July 1989. Therefore, the Partners claim that this is in itself prima facie proof that Henkels was not a creditor -- i.e., Henkels was not owed any money at the time of the distributions. These arguments, however, take a very narrow and ultimately erroneous legal view of the contractual relationship with Henkels and even a more constricted view of the definition of creditor.

Although the term creditor is undefined in the New Jersey ULPL and there is no New Jersey case law interpreting the term in this context, the term creditor is not foreign to New Jersey law. For instance, many New Jersey statutes define creditor very broadly to include "the holder of any claim, of whatever character, . . . whether

authority and decision making power, including: "[t]he right to incur liabilities on behalf of the [Chestnut Woods Partnership] in connection with the reasonable and legitimate business of the [Chestnut Woods Partnership]." In addition, Paragraph 13.1(n) delegated the right and power "to enter into such contracts or agreements deemed necessary or appropriate on behalf of the [Chestnut Woods Partnership]." It is significant that these provisions, unlike paragraphs 13.1(d), (g), (j), (l), & (m), allowed Cedar Ridge to incur "on behalf of the [Chestnut Woods Partnership]," and did not require that it incur liabilities and enter contracts only "in the name of the [Chestnut Woods Partnership]." (emphasis added).

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secured or unsecured, matured or unmatured, liquidated or unliquidated, absolute or contingent." See N.J. Stat. Ann. S 14A:14-1(b) (Business Corporation Act); N.J. Stat. Ann. S 15A:12-18(c) (Nonprofit Corporation Act); and N.J. Stat. Ann. S 25:2-7 (Uniform Fraudulent Conveyance Act) (repealed), & N.J. Stat. Ann. S 12A:6-109 cmt. (UCC Bulk Transfers) (repealed). Cf. *City of Philadelphia v. Stepan Chem. Co.*, 713 F. Supp. 1491, 1493 n.3 (E.D. Pa. 1989) (to qualify as creditor, a party's claim must be based on "some legal foundation, such as an underlying debt, a contract, or a lawsuit"). Also, the statute is remedial in nature, "designed to protect creditors and should be interpreted with this purpose in mind." *Henkels & McCoy, Inc.*, 906 F. Supp. at 252-53. In addition, the generic common law definition of creditor is very broad and

includes every one having [the] right to require the performance of any legal obligation [or] contract, . . . or a legal right to damages growing out of [a] contract or tort, and includes not merely the holder of a fixed and certain present debt, but every one having a right to require the performance of any legal obligation [or] contract, . . . or a legal right to damages growing out of [a] contract or tort.

Black's Law Dictionary 368 (6th ed. 1990) (emphasis added). Finally, the failure of the statute to define creditor is indicative of the New Jersey legislature's intent that the term "creditor" be construed consistent with the New Jersey ULPL's broad remedial purpose and its common usage. See N.J. Stat. Ann. S 1:1-1 (General rules of construction). The district court cited many of these reasons and found them sufficiently persuasive, as do we, to adopt a broad definition of creditor which includes unmatured payments of a debt upon performance under a contract such as Henkels's.

Pursuant to the subcontract agreement, Henkels had a claim to payment for a fixed contract price to be paid in installments upon progressive completion of the sewer work. Although the Partners argue that Henkels did not have a claim at the time of the 1989 distributions, the contract between Henkels and Cedar Ridge was entered into on December 29, 1988. Thus Henkels and Cedar Ridge

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had definite obligations to each other under the contract over a week prior to the first distribution by the general partner to the Red Hawk limited partners. Those obligations required Henkels to make the site improvements and Cedar Ridge to make scheduled payments as performance was rendered. In addition, G&A made the bulk of the distributions after Henkels had commenced work and was incurring costs and expenses in fulfilling its commitments under the contract. Thus Chestnut Woods and Red Hawk had incurred liability as early as December 29, 1988, although the bulk of the payment matured the month after the last distribution by Red Hawk to the Partners. The Partners' overly narrow definition of creditor is inconsistent with the obvious financial realities that existed at the time, the generally accepted common law meaning of the term, the broad definition used in other New Jersey statutory contexts, and the broad remedial purpose of the statute. Accordingly, we hold that under this broad definition and consistent with the principles of agency and partnership law previously discussed, Henkels was not only a creditor of Cedar Ridge, but of Chestnut Woods, and thus Red Hawk and its partners.

The Partners further argue that even if we conclude that Henkels was a creditor of Chestnut Woods, Red Hawk was not "jointly and severally" liable for the partnership's debts, but only "jointly" liable, as it was only a partner in Chestnut Woods. The Partners find this significant and contend that as a partner Red Hawk was only contingently liable as a guarantor of collection, not as a guarantor of payment. Furthermore, the Partners contend that even then Red Hawk was not liable until Henkels had obtained a judgment against the Chestnut Woods partnership, was unable to collect, and then sought payment from Chestnut Woods's partner, Red Hawk. Therefore, the Partners

conclude, Henkels was not a creditor of Red Hawk until this eventuality ultimately did occur in October 1991--more than two years after the distributions. Thus, they assert there was no violation of Section 42:2A-46(b) or the partnership agreement. Although the Partners make much of the distinction between "joint" and "joint and several liability," and between "guarantor of collection" and

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"guarantor of payment," the distinctions between these terms are illusory here and are not dispositive.

Under the New Jersey ULPL, partners are only jointly liable for contract obligations of the partnership, and thus a contract creditor of the partnership must first exhaust the partnership's assets before it can pursue the assets of the individual partners. See N.J. Stat. Ann. S 42:1-15(b). The Partners dwell on their argument that joint liability means that partners are merely guarantors of collection rather than guarantors of payment, citing *Seventy-Three Land, Inc. v. Maxlaw Partners*, 637 A.2d 202 (N.J. Super. Ct. App. Div. 1994). They contend that this distinction means that Henkels was not a creditor of Red Hawk until after it obtained a judgment against Red Hawk's assets in October 1991, "long after the distributions to the limited partners were made."

This argument is without merit, however, because the Partners overly emphasize the distinction between guarantor of collection and guarantor of payment by ignoring the sentence in *Seventy-Three Land, Inc.* immediately preceding the courts' discussion of this distinction; that sentence actually supports an opposite conclusion. The court in *Seventy-Three Land, Inc.* merely stated that "[p]artners are liable for partnership contract debts, but their assets are not at risk until it is shown that the partnership cannot discharge the debt." *Id.* at 204 (emphasis added). This language, consistent with the broad definition of creditor previously discussed, clearly demonstrates that jointly liable partners such as Red Hawk do have a present liability. The significance to the Red Hawk Partners is that payment of that liability out of their individual assets is contingent, rather than fixed, until the partnership's assets are first exhausted. Although the Partners' individual assets were only contingently at risk, the Partners nonetheless were liable to Henkels from the time the contract was signed and, as ultimately did happen, their assets did become available when the Red Hawk partnership's assets proved insufficient to meet its debt with Henkels.

Accordingly, we hold that the district court's finding that Henkels was a creditor of Red Hawk was correct. See

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Henkels & McCoy, 906 F. Supp. at 252-53. At the time of the 1989 distributions, Henkels was a creditor of Red Hawk and the individual Red Hawk partners were liable for that debt.⁸

III.

Although Henkels was a creditor of Red Hawk, the 1989 distributions were in violation of the partnership agreement only if, as Henkels argues, Red Hawk's distributions constituted a failure to abide by the partnership agreement's requirement to establish reasonably necessary reserves. The Partners, however, contend that the district court made several errors in interpreting the Red Hawk partnership agreement which resulted in its finding that the distributions were in violation of the agreement by failing to establish such reasonable reserves.

Section 9(b) of the partnership agreement grants the general partner, G&A, certain rights and powers, including, under subsection (ix), the power "to establish reasonable reserve funds from income derived from the Partnership's operations to provide for future . . . debt service or similar requirements." The Partners argue that this subsection is the only subsection of the agreement that permits or authorizes the general partner to reserve funds. Thus, according to the Partners, all reserves had to be (1) authorized by this subsection, (2) taken from income derived from operations, and (3) used for debt service. Therefore, had G&A reserved funds against the Henkels

8. The dissent would extend our holding far beyond its limit. It concludes that the majority holds "by necessary implication. . . that a distribution could not be made to Red Hawk partners unless cash reserves had been established to fund the payment of all anticipated future liabilities of the joint venture partnerships (owned in part by others) that might accrue over some unspecified period of time" Dissent at p. 30. We are not called upon in this case to decide whether reserves are required for "all anticipated future liabilities" and therefore the majority does not decide that question, either directly or by implication. The focus of our holding is merely that when there is clear liability under an existing contract, the equity partners cannot ignore that liability, recapture their capital investments, and leave the creditor spinning in the wind.

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contract, the Partners contend that such reserves would have been taken in violation of this subsection of the partnership agreement because the funds would not have been derived from operations but from distributions of capital.

The Partners' argument fails, however, because it selectively presents the language of Sections 9 and 12 and omits other relevant language which demonstrates that the Partners greatly overemphasize the significance of

subsection (ix). First, the express language of Section 9(b) provides that the general partner possess all "rights and powers required for or appropriate to its management of the partnership's business which, by way of illustration but not by way of limitation, shall include the following: . . . (ix) to establish reasonable reserve funds from income derived from the partnership's operations to provide for future . . . debt service or similar requirements." This unambiguous language demonstrates that G&A had the right and power to establish reserves, even if not expressly authorized under subsection (ix), if it deemed them required or appropriate for the management of Red Hawk's business. The list of rights and powers in subsection (ix) is merely illustrative and is not an exclusive limitation on the general partner's rights and powers.

Equally important, as the district court properly found, the distributions at issue here were not taken from income derived from operations, but were merely returns of capital of the aborted Timber Knolls partnership, which, as Red Hawk admits, "never got off the ground." Income from "operations," as used in this subsection, refers to income derived from the active, normal, on-going activities of the partnership. Timber Knolls never functioned, and thus there never was any income from operations. Therefore, subsection (ix) is not applicable to the distributions at issue here.⁹ It is completely irrelevant because the distributions

9. This point is significant in interpreting Section 12(a) as well. Following the order of priority for the distributions of cash receipts in Section 12(a) (i)-(v) is a provision which prohibits the general partner from "retain[ing] and invest[ing] any Cash Receipts derived from the operations of the Property, except . . . (2) for investments of reserves permitted to be established under clause (ix) of Paragraph 9(b)." (emphasis added). Because the cash receipts used to fund the distributions were not derived from income from operations of Red Hawk property, this prohibition is not relevant to this appeal.

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constituted capital funds retrieved by Red Hawk from its abandoned project, Timber Knolls. Although the Partners emphasize that the funds were derived from the Timber Knolls project, Subsection (ix) only addresses the reserving of funds derived from operations; the germinating project is immaterial.

Finally, as previously discussed, Henkels qualified as a creditor of Red Hawk at the time the distributions were made. Therefore, pursuant to Section 12(a) of the Red Hawk limited partnership agreement governing the distribution of all cash receipts, the Red Hawk general partner was required to establish reasonable reserves from the cash received on the Timber Knolls promissory notes to meet its ongoing liability before distributing such cash to the individual limited partners. We, therefore, turn to the issue as to what would constitute a "reasonable" reserve to meet

the outstanding liability under the Henkels subcontract.

Although neither party provided the district court with any case law or treatise defining reasonable reserves, the court used the Black's Law Dictionary definition of "reasonable" and of "reserves" in the insurance context to define reasonable reserves in the business context before us. We agree with them that the insurance context is inappropriate for analysis because the nature of the insurance business differs significantly from that of an ordinary business partnership. Unlike an ordinary business partnership, an insurance company essentially is required to meet future, contingent obligations, and these reserves are required. The Partners instead propose that the highly deferential corporate "business judgment" standard is the appropriate standard. However, as Henkels correctly argues, the business judgment rule also is inapposite in the partnership context because it is a function of a unique corporate setting. See 3A William Meade Fletcher et al., Fletcher Cyclopedia of the Law of Private Corporations SS1036-37 (perm. ed. rev. vol. 1994).

Although the New Jersey courts have not yet addressed the issue of what constitutes reasonable reserves, we do not need to expressly define reasonable reserves in the context of this case because it is unnecessary to the disposition of this appeal. See *Rush v. Scott Specialty Gases, Inc.*, 113

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F.3d 476, 486 (3d Cir. 1997) (declining to decide issues unnecessary to the appeal); *Georgine v. Amchem Products, Inc.*, 83 F.3d 610, 623 (3d Cir. 1996) ("[W]e believe it prudent not to decide issues unnecessary to the disposition of the case."). Regardless of what standard the New Jersey courts will ultimately adopt, under any standard and using any definition of reasonable reserves, the Red Hawk general partner's failure to establish any reserves in the face of the fixed obligation and imminent payments due under the contract with Henkels and the operations of the Chestnut Woods development was callous and not reasonable.

It is undisputed that of the approximately \$500,000 monies received by Red Hawk in 1989, the Red Hawk general partner (G&A) did not set aside any of these funds to establish reserves, even in the face of a contracted liability. Red Hawk argues, however, that this was not unreasonable because (1) the Red Hawk partnership had no liabilities and \$3 million in assets at the time of the distributions; (2) Henkels had not yet invoiced Chestnut Woods; (3) the financial outlook of Red Hawk (& Chestnut Woods) was healthy; and (4) the express terms of the partnership agreement prohibited the taking of such reserves. Each of these contentions is without merit.

First, the \$3 million of assets included on Red Hawk's January 1, 1989 balance sheet is somewhat illusory. Of the \$3 million in assets, a scant \$22,000 was in the form of

cash or other liquid assets. The remaining were almost exclusively illiquid: the \$800,000 investment in the Chestnut Woods project itself which consisted of land and infrastructure and the \$2.1 million Timber Knolls notes receivable from Cedar Ridge -- which were substantially distributed to the limited partners. Neither of these assets were readily available to satisfy Red Hawk obligations, especially not after the payments on the notes were distributed to the partners. Moreover, Red Hawk repeatedly left almost no money in its checking account after each distribution to the Partners, other than several thousand dollars to cover incidental operating expenses. Additionally, the absence of any formal liabilities from its balance sheet and the failure of Henkels to physically invoice Cedar Ridge did not mean that Red Hawk had no liabilities; it simply

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was an "off-balance sheet" liability. In the accounting profession, an "off-balance sheet" liability is a financial obligation that is not formally recognized in an entity's accounting statements because no "accounting" obligation arises until the exchange transactions is completed; nonetheless, they do have real current and future cash flow consequences. See Accountant's Handbook, 10.29 (7th ed. 1991). Under the broad definition of creditor established above, Red Hawk had an unmatured, fixed, off-balance sheet liability to Henkels.

Although by itself this may be not determinative, more telling is the Partners' failure to identify any other source of funds from which the Red Hawk Partnership would be able to meet its obligations, including its contract obligation to Henkels. The Timber Knolls project never got off the ground, literally and figuratively, and based on the record, Chestnut Woods generated no earnings during the 1989 tax year and Red Hawk generated none during both 1988 and 1989. Because the Chestnut Woods property was under development at the time, Chestnut Woods reported a loss during 1989 and Red Hawk reported losses on both its 1988 and 1989 tax returns, and both Chestnut Woods and Red Hawk appear to have had negative cash flows during these years. Without any other source of cash or liquid assets, short of liquidating the Chestnut Woods property itself, it clearly was unreasonable for G&A to distribute to the Partners Red Hawk's only available source of payment without setting aside any reserves to meet the Henkels debt.¹⁰

10. As we noted above, see *supra* p. 10, under the New Jersey partnership statute and fundamental principles of agency law, every partner is an agent of the partnership and the act of every partner binds the partnership for the purpose of its business. Accordingly, the liability of the Red Hawk partnership to Henkels was committed by written contract between Henkels and Red Hawk's partner, Cedar Ridge, in December 1988, before any retrieval by the Partners of their capital investment in Timber Knolls. In addition, Red Hawk's project, Chestnut Woods, had current liabilities as of January 1, 1989, according to its tax

returns, which disclosed debts of over \$1.7 million. These liabilities also were in place prior to the retrieval of the Partners' investments in Red Hawk. Nevertheless, the dissent would relieve the Partners of any liability under the contract to creditor Henkels on the theory that from January to August 1989, Red Hawk "had no significant liabilities of any kind." Dissent at p. 29.

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Second, and equally telling, G&A knew, or at least had ample notice, that the financial outlook of Red Hawk and Chestnut Woods was not as rosy at the time of the distributions as the Partners attempt to assert now. 11 For example, the Partners fail to mention or accurately state many of the following facts: (1) Red Hawk and G&A, in December 1988, received notification from Cedar Ridge that four separate and distinct types of delays in the Chestnut Woods project were resulting in additional financial burdens to it; (2) Cedar Ridge also informed Red Hawk that these financial burdens were worrisome given the decline already experienced in the housing market; (3) Red Hawk had a scant \$22,000 in cash or other liquid assets on hand as of January 1, 1989; (4) Chestnut Woods had an equally scant \$12,000 in cash or other liquid assets on hand as of January 1, 1989; (5) Chestnut Woods' January 1, 1989 balance sheet showed over \$1.7 million in current liabilities, with the land and construction in progress of Chestnut Woods comprising over 90% of its \$2.4 million in assets, leaving meager resources available to pay for the planned 1989 site improvements, such as the \$300,000 of sewer systems from Henkels;¹² (6) as of March 7, 1989, Red Hawk had, at a minimum, imputed knowledge from its bank's written notice that interest on the Chestnut Woods mortgage would no longer be paid out of the interest reserve fund and that Cedar Ridge was responsible to pay

11. Even assuming arguendo that Red Hawk and G&A did not have actual notice or knowledge of the precarious financial condition of Chestnut Woods, "[t]here are many cases stating the general rule that knowledge of one partner [(Cedar Ridge)] will be imputed to the others." Harold Gill Reuschlein & William A. Gregory, *The Law of Agency and Partnership* S200 at 304 (1990); see also N.J. Stat. Ann. S 42:1-12 ("Knowledge to any partner of any matter relating to partnership affairs . . . operate[s] as notice to or knowledge of the partnership . . ."); *Clafflin v. Wolff*, 96 A. 73, 79 (N.J. 1915) ("If any of [the partners] had notice or knowledge . . . they would all be affected by it.").

12. Red Hawk states, and its 1989 tax return shows, that Chestnut Woods' assets were \$2.4 million, not \$1.8 million. Although the district court found the number to be \$1.8 million, this difference is inconsequential; either amount consisted almost exclusively of the project's land and work-in-progress -- i.e., illiquid assets, leaving next to nothing to pay its \$1.7 million in current liabilities.

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interest out of its own funds due to "the past unfortunate circumstances [which] caused slower than expected [progress on the Chestnut Woods project,]" and which caused the remaining interest reserve to become substantially depleted and potentially "insufficient to carry this loan;" and (7) the August 1989 \$2.7 million appraisal of the Chestnut Woods project was merely a potential future retail estimate and contained the express caveat that this "value estimate[] assume[s] that all site improvements will be completed in a workmanlike manner and within a reasonable period of time."¹³

Finally, as previously discussed, the Red Hawk partnership agreement did not prohibit G&A from reserving funds for the payment of Henkels. Section 9(b)(ix) is merely an illustration of G&A's rights and powers and, because the funds at issue were not derived from operations, ultimately was irrelevant to the funds at issue. More importantly, Section 12(a) expressly required that the available cash funds be used to establish reserves before they were distributed to the Partners.

13. The dissent ignores the foregoing realities of Red Hawk's and Chestnut Woods' financial straits while the Chestnut Woods project was still under development, and already beset by a negative cash flow in the project, while at the same time the Partners were retrieving all of their total capital investments in the Timber Knolls project. The dissent, again, would permit the Partners to escape liability in the face of Henkels' 1988 contract on the infirm premise that at the end of August 1989, when all partner contributions had been repaid, Chestnut Woods had the project appraised at \$2.7 million and Red Hawk "had significant net worth throughout this period." Dissent at p. 30. In the first place, the appraisal obtained by Chestnut Woods was merely an optimistic, potential, retail figure dependent on the market price for the lots, when and if sold, and the completion of the project "in a workmanlike manner and within a reasonable period of time." Second, even if the appraisal of the project were accurate, the frozen nature of the real estate -- not yet marketable -- provided no liquid source for payment of ongoing obligations. To illustrate, it could not meet the payment due of \$215,175 for the August delivery by Henkels. Further significant, Red Hawk and Chestnut Woods both reported losses during 1989, and both appear to have had negative cash flows. Both had meager sums of cash on hand, and Chestnut Woods had significant current liabilities with 90% of its assets frozen.

Although neither Henkels nor the district court attempted to determine what level of reserves was reasonable, no determination was needed because Red Hawk and G&A failed to establish any reserves. It is patently obvious that at least some level of reserves was reasonably necessary, and that the general partners' distributions and failure to reserve any money for the Henkels contract obligation, in light of Chestnut Woods' and Red Hawk's precarious financial condition, was unreasonable. Thus, the district

court did not need to determine what level of reserves was reasonable; it clearly had an ample factual basis upon which to determine that the complete failure to establish any reserves was a violation of the Red Hawk partnership agreement's requirement that G&A establish some level of reserves before making distributions to the Partners. Accordingly, we hold that Red Hawk's failure to establish any reserves in light of both partnerships' then existing financial condition was not reasonable.

IV.

In conclusion, we find no merit to appellants' contentions. We see no error in the district court's conclusion that Henkels was a creditor of Red Hawk, and therefore the 1989 capital distributions to the Partners and failure to establish any reserves to fund its contract obligation to Henkels was a violation of the Red Hawk partnership agreement. The Partners are therefore obligated to return the improper capital distributions to Red Hawk. Because the plaintiff stands in the shoes of Red Hawk for the purpose of recovering these funds on behalf of the partnership, *In re: Sharps Run Associates*, 157 B.R. 766, 772-73 (D.N.J. 1993), and because of the multiple suits it already has been compelled to undergo to enforce collection of its debt, judicial resources will be conserved and economies of time and expenses effectuated, to hold the Partners directly liable to Henkels.

Accordingly, the judgment of the district court will be affirmed. Costs taxed against the appellants.

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STAPLETON, Circuit Judge, Dissenting:

The critical issue posed by this appeal is one of intent - the intent of the Red Hawk partners when they negotiated their partnership agreement. Given the text of that agreement and the context in which it was executed, I believe the district court clearly erred when it interpreted Section 12(a)(iv) as precluding the three challenged payments to Red Hawk's limited partners.

The relevant facts are documented and undisputed. Red Hawk is a limited partnership organized under the New Jersey Uniformed Limited Partnership Law to facilitate the investment of its corporate general partner and its individual limited partners in two specific real estate developments. The sole declared purpose of the partnership was to participate in two joint ventures pursuant to identified, previously executed joint venture agreements, each of which would independently develop a parcel of real estate in Bucks County, Pennsylvania. The Timber Knoll joint venture was to develop the Timber Knoll property; the Chestnut Woods joint venture was to develop the Chestnut Woods property. In each instance, management of the joint venture was placed in the hands of an unrelated

corporation with experience in the business of real estate development, the Cedar Ridge Development Corporation. The partners of Red Hawk contributed to it capital of \$3.5 million. Of this capital, \$2.3 million was committed to the Timber Knoll joint venture, and \$850,000 was committed to the Chestnut Woods joint venture. It was understood that Cedar Ridge would be simultaneously involved in other real estate development projects in New Jersey, Pennsylvania, and other states.

Under the Chestnut Woods joint venture agreement, Cedar Ridge, as the "Managing Partner," was authorized to borrow money and to mortgage and sell assets. Red Hawk was to receive a Preferred Minimum Return on Capital prior to any distribution of profits to Cedar Ridge. The preferred return was equal to 15% "per annum based on simple interest payable quarterly on the amount of capital outstanding and not returned." J.A. at 91. However, "in the event the net cash working reserve of the [joint venture fell] below \$500,000, the quarterly preferred return [could] be

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deferred by the MANAGING PARTNER until the net cash working reserve has sufficient cash in excess of \$500,000 to pay the unpaid preferred return." J.A. at 91-92. The agreement further provided that no partners would have "the right to compel a distribution of profits or cash, unless the [joint venture] has accumulated an unwarranted amount of cash not reasonably needed for future business activities." J.A. at 93-94. Red Hawk's capital contribution was to be returned at the minimum rate of \$12,400 per lot sold after the sale of the first 20 lots. In addition, the managing partner committed itself to "make a good faith effort to make minimum annual cash distributions equal to thirty-five percent (35%) of the distributive share of profits allocated to each PARTNER" for tax purposes. J.A. at 94. Distributions could be made in cash or property.

It was in the context of this joint venture agreement and the similar Timber Knoll joint venture agreement that the Red Hawk Partnership Agreement was negotiated. Since the Red Hawk partners understood that cash flow would be coming to Red Hawk from the managing partner of the joint ventures only after Cedar Ridge had established reserves to service the only business operations in which Red Hawk would ever have an interest, the Red Hawk limited partners understandably sought assurance that joint venture profits and return of capital would not be accumulated in the Red Hawk partnership by its general partner, G&A.

The Red Hawk Partnership Agreement thus provided for a mandatory pass-through of cash receipts, whether generated by the joint ventures in the regular course of business or otherwise, after the general partner had paid all of the currently due debt obligations of Red Hawk and had set aside specifically limited reserves. Any reserves were expressly limited to such revenue from operations as the

general partner, in its discretion, considered appropriate for the purpose of paying anticipated administrative expenses and, in the event of the distribution of joint venture property in kind, anticipated property management expenses. Section 12(a) of the agreement thus provided:

(a) Application of Cash Receipts. Cash Receipts shall be applied in the following order of priority:

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(i) to the extent required, to the creditors of the Partnership, except to any Partner or any Affiliate thereof;

(ii) to the extent required, to the payment of any debts or liabilities to any Partner or any Affiliate thereof (other than a loan to the Partnership by the Partner);

(iii) to the payment in full of any loans to the Partnership by a Partner;

(iv) to the establishment of such reserves as the General Partner shall reasonably deem necessary; and

(v) to distributions to the Partners in accordance with Paragraphs 12(b) and (c) hereof.

Notwithstanding the foregoing, the General Partner shall not retain and invest any Cash Receipts derived from the operations of the Property, except (1) to defray expenditures for any repair or improvement to any Property, which it, in its sole discretion, deems appropriate or (2) for investments of reserves permitted to be established under clause (ix) of Paragraph 9(b) hereof, nor shall the General Partner invest the net proceeds derived and retained by the Partnership from the sale or other disposition of any Property (including any total condemnation or destruction of any portion of the Property) except as otherwise provided herein.

J.A. at 274.

The term "Property" is defined in the Red Hawk Agreement to mean "the Buildings and Land in Bucks County, Pennsylvania." J.A. at 261. "Cash Receipts" means "all cash receipts of the Partnership from whatever source derived." J.A. at 259. Section 9 of that Agreement is entitled "Rights and Duties of the General Partner." It imposes no duty on the General Partner to set aside reserves for any purpose. In subsection (b)(ix), the subsection referenced in Section 12(a), the general partner is given the authority "to establish reasonable reserve funds from income derived from the Partnership's operations to provide for future

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maintenance, repair, replacement, debt service or similar requirements." J.A. at 265.

Read in the context of the Agreement and the expectations of the Partners, it is apparent that the dominant portion of Sections 12(a) is the paragraph commencing with the clause "Notwithstanding the foregoing." Indeed, that lead clause requires that this paragraph be given controlling significance over the preceding text. It mandates disbursement to the partners of all cash whether received by Red Hawk in the course of the normal operations of the joint venture properties or whether received by it from dispositions of joint venture property other than in the course of its regular business operations. The two exceptions recognize that the General Partner, in its sole discretion, should have the ability to retain cash derived from operations to establish reasonable reserves for property repairs and improvement, debt service, and other operating expenses.

The subordinate portion of Section 12(a) that precedes the "notwithstanding" clause establishes the priorities among various interests that may compete for distributions of cash receipts. The purpose of subsection 12(a)(iv), in particular, is (1) to recognize the possibility that the General Partner may wish to withhold some funds pursuant to the two express exceptions from the flow through mandate; and (2) to emphasize that the General Partner's authority to do so is limited to such reserves as it might "reasonably deem necessary." Thus, subsection 12(a) is designed both to recognize the possibility of retention of cash receipts for authorized reserves at the discretion of the General Partner and, at the same time, to assure the limited partners that there will be no accumulation of even funds for reserves when the general partner, in the exercise of business judgment, could not reasonably regard them as necessary for the designated purposes.

The Timber Knoll project never got off the ground. The requisite governmental approvals for development were not obtained by the owner of the Timber Knoll site, and the property was never purchased by the joint venture. When it appeared that the objective of the joint venture would have to be abandoned, an amendment to the joint venture

agreement was executed that called for the conversion of Red Hawk's \$2.3 million capital contribution into promissory notes of Cedar Ridge. Pursuant to these notes, payments were received by Red Hawk in January 1989, April 1989, and July 1989. These payments represented a return of the capital contribution made by Red Hawk to the Timber Knoll joint venture and interest accrued thereon after the conversion.

The Chestnut Woods project did get underway in late 1988. Cedar Ridge served the Chestnut Woods joint venture not only as managing partner, but also as "general contractor" for the site improvements. The site improvements were to be financed, at least in part, through bank borrowing. Among these improvements were, of course, storm and sanitary sewer systems. Cedar Ridge, in its capacity as "general contractor," contracted with plaintiff Henkels & McCoy in December of 1988. Henkels commenced its work at the Chestnut Woods site on January 16, 1989, shortly after Red Hawk received the first payment on the return of its capital contribution to the Timber Knoll joint venture.

In January, April and July of 1989, Red Hawk's general partner made the decisions that gave rise to this lawsuit. When each return of capital from the Timber Knoll project was received, G&A decided to deposit a few thousand dollars in Red Hawk's checking account to cover anticipated administrative expenses and to return the remainder to the limited partners. Henkels seeks to compel return of those distributions to Red Hawk for application to a default judgment it later obtained against Red Hawk.

During the period from January to August 1989, Red Hawk had satisfied its entire capital commitment to the Chestnut Woods joint venture, and it had no significant liabilities of any kind. It was receiving reports from Cedar Ridge that site improvements, after some initial delays, were progressing. Cedar Ridge estimated at the start of this period (i.e., December 1988) that, even without improvements, the entire property could be sold for approximately \$78,000 per lot, i.e., \$1.8 million. At the end of this period (i.e., August 1989), the Chestnut Woods

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project was appraised at \$2.7 million. It is undisputed that Red Hawk had significant net worth throughout this period.

The district court found it significant that Red Hawk and its partners understood that site improvements were on-going during the period from January to July 1989 and that the Chestnut Woods joint venture was, accordingly, incurring liabilities. It did not find, however, that this joint venture was insolvent during this period. To the contrary, the record relevant to this period indicates that the liabilities of the Chestnut Woods joint venture did not exceed \$1.7 million, that it thus remained solvent, and that trade creditors were being paid on a current basis. In particular, all invoices that were submitted to Cedar Ridge by Henkels during this period were paid in full.

New Jersey's Uniform Limited Partnership Law provides that a partner may not receive a distribution from a limited partnership "to the extent that, after giving effect to the distribution, all liabilities of the limited partnership, other

than liabilities to partners on account of their partnership interests, exceed the fair value of the partnership assets." N.J. Stat. Ann. S 42:2A-45. This is the sole mandatory restriction in the law for the benefit of partnership creditors on distributions to partners. Any additional restriction for the benefit of creditors must thus be one voluntarily undertaken by the Red Hawk partners in their partnership agreement.

Our court today holds that the Red Hawk partners, although mandating a pass-through to themselves of cash receipts, intended in Section 12(a) of their partnership agreement voluntarily to impose on themselves a very significant restriction for the benefit of joint venture creditors. This voluntary restriction, the court holds by necessary implication, was intended to be sufficiently broad that a distribution could not be made to Red Hawk partners unless cash reserves had been established to fund the payment of all anticipated future liabilities of the joint venture partnerships (owned in part by others) that might accrue over some unspecified period of time, even though those other partnerships were expected to pay their own liabilities with their own or borrowed funds. The record suggests no reason, however, why the partners, when

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setting up the Red Hawk partnership, would have imposed such an unnecessary and ill-defined burden on themselves, and the text of Section 12(a) does not require such a conclusion that they did.

The court resolves the central issue in this appeal in one sentence: Section 12(a) (iv) "of the Red Hawk partnership agreement specifically provided that cash receipts be used for the establishment of reasonable reserves (for creditors) before such receipts be distributed to the [limited partners]." Slip opinion at 10. Because Red Hawk's general partner had reason to believe that Henkels might submit invoices in the future for site improvement work, the court accordingly concludes that the three challenged distributions violated Section 12(a) (iv).

In my view, the court errs for at least five reasons: (1) In context, Section 12(a) (iv) was intended for the protection of the limited partners, not as a creditor protection device even for creditors of Red Hawk; (2) Section 12(a) (iv), even if viewed as a creditor protection provision, was not intended for the protection of joint venture creditors for whom the joint ventures were to make other provision; (3) the challenged distributions were a return of capital that the partners had agreed to devote to an abandoned venture, and it is not reasonable to find an intent in Section 12(a) (iv) to commit that capital contribution to the creditors of a different, fully capitalized venture; (4) Section 12(a) (iv) permits the general partner to retain reserves only from "Cash Receipts derived from the operations of the Property" and the challenged distributions did not come from funds

generated by operations;1 and (5) even if Section 12(a)(iv)

1. The district court correctly found that the three payments representing a return of the capital committed to the Timber Knoll joint venture did not constitute a "cash receipt from the operations of the Property." It inexplicably concluded from this, however, that the general partner was thus "plainly obligated" to follow the terms of Section 12(a)(iv) and establish a reserve for anticipated future liabilities to Henkels. At the time the Red Hawk partnership agreement was negotiated, the parties were not, of course, anticipating the abandonment of the Timber Knoll venture, and the "notwithstanding" clause does not literally read as applying to a return of capital that does

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could reasonably be read to require Red Hawk's general partner to set aside funds for creditors in Henkels' position whenever a reasonable general partner exercising business judgment would do so, this record provides no basis for a conclusion that the failure of Red Hawk's general partner to set aside funds for Henkels in January through July of 1989 was a decision beyond the bounds of business judgment.

I would reverse and remand with instructions to enter judgment for the defendants.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

not result from a sale of the joint venture property. Nevertheless, I believe the intent behind the provision governing such sales, and the provisions strictly limiting the objectives of the partnership to participation in specified joint ventures with specified capitalization, required a pass-through of the payments from the Timber Knoll joint venture. But whether or not this is the case, I find no authority in the agreement for the establishment of reserves other than out of operating revenues.

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GREAT LAKES CHEMICAL CORPORATION, Plaintiff, v. MONSANTO
COMPANY and SWEET TECHNOLOGIES, INC., Defendants.

Civil Action No. 00-043-RRM

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF DELAWARE

96 F. Supp. 2d 376; 2000 U.S. Dist. LEXIS 7307; Fed. Sec. L. Rep. (CCH) P90,988

May 25, 2000, Decided

DISPOSITION: [****1**] Defendants' motion to dismiss all counts of plaintiff's complaint granted.

COUNSEL: William M. Lafferty, Esquire, and Jessica Zeldin, Esquire, Morris Nichols Arsht & Tunnell, Wilmington, Delaware, for plaintiff.

H. Roderic Heard, Esquire, John L. Eisel, Esquire, Thomas M. Lynch, Esquire, Tina M. Caravette, Esquire, and Samuel S. Cohen, Esquire, Wildman, Harrold, Allen & Dixon, Chicago, Illinois, for plaintiff.

Richard L. Horwitz, Esquire, and John M. Seaman, Esquire, Potter Anderson & Corroon LLP, Wilmington, Delaware, for defendants.

John W. Treece, Esquire, and Sheila A. Sundvall, Esquire, Sidley & Austin, Chicago, Illinois, for defendants.

JUDGES: McKELVIE, District Judge.

OPINIONBY: McKELVIE

OPINION: [***376**]

Wilmington, Delaware

May 25, 2000

McKELVIE, District Judge

This is a securities case. Plaintiff Great Lakes Chemical Corporation is a Delaware corporation with its principal place of business in Indianapolis, Indiana. Defendants Monsanto Company and its wholly owned subsidiary, Sweet Technologies, Inc. [***377**] ("STI"), are Delaware corporations with their principal places of business in St. Louis, Missouri.

On May 3, 1999, Great Lakes purchased NSC Technologies Company, LLC ("NSC"), [****2**] from Monsanto and STI. NSC is a Delaware limited liability company with its principal place of business in Mount Prospect, Illinois.

On January 4, 2000, Great Lakes filed the complaint in this action, alleging that Monsanto and STI violated § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j)(b) and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, by failing to disclose material information in conjunction with the sale of NSC. Great Lakes also alleges that defendants are liable for violating Indiana securities law, engaging in common law fraud, and breaching the sale contract, and that defendants must indemnify Great Lakes for all costs arising from the breaches of their representations and

warranties in the purchase agreement. Great Lakes is seeking compensatory damages, punitive damages, indemnification, costs, fees, and rescission of the purchase agreement. With respect to a subsidiary agreement, Great Lakes is seeking a declaratory judgment that Monsanto is in breach of the agreement, and an order for specific performance of Monsanto's duties arising thereunder, or an award of consequential damages.

On March 9, 2000, Monsanto and [**3] STI moved to dismiss the complaint pursuant to Fed. R. Civ. P. 9(b) and 12(b)(6), for failure to plead fraud with specificity and for failure to state a claim upon which relief may be granted. Among their assertions, Monsanto and STI argue that the interests sold to Great Lakes were not "securities," as defined by § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(a)(1), and that Great Lakes has failed to plead adequate facts in support of its claim for securities fraud.

The parties have completed briefing on defendants' motion. On May 2, 2000, the court heard oral argument on the motion. This is the court's decision on defendants' motion to dismiss.

I. FACTUAL AND PROCEDURAL BACKGROUND

The court draws the following facts from the complaint and the documents attached to the complaint that have been incorporated by reference therein. For the purposes of a motion to dismiss, the court accepts all allegations in the complaint as true and draws all reasonable inferences in favor of Great Lakes. See *Rocks v. Philadelphia*, 868 F.2d 644, 645 (3d Cir. 1989).

A. The Formation of NSC

1. Creation of the NSC Unit within Monsanto [**4]

Monsanto is the world's largest manufacturer and distributor of L-phenylalanine ("L-phe"), an amino acid that is a principal ingredient in the sweetener aspartame. Monsanto manufactures and sells aspartame as the product NutraSweet. L-phe is also useful in the production of numerous pharmaceutical products.

In approximately 1985, Monsanto created the NSC Unit within its NutraSweet division to develop specialized pharmaceutical intermediates and pharmaceutical active compounds derived from L-phe. In 1995, Monsanto reorganized its NutraSweet division and established the NSC Unit as a separate reporting division of Monsanto Growth Enterprises. Monsanto retained the commercial rights to manufacture and sell L-phe and aspartame to the sweetener market. Monsanto restricted the NSC Unit's sales of L-phe to the pharmaceutical market and to a single customer in the sweetener market, Enzymologa, a Mexican manufacturer of aspartame. By 1998, the NSC Unit's principal business was based on the development and sale of L-phe and Tic-D, a pharmaceutical intermediate derived from L-phe. [*378]

2. Creation of NSC as a Limited Liability Company

On September 25, 1998, Monsanto entered into an agreement [**5] (the "LLC Agreement") with STI to establish the NSC Unit as a limited liability company called NSC Technologies Company, LLC ("NSC"), pursuant to the Delaware Limited Liability Company Act, 6 Del. C. § 18-101 et seq. The following terms of the LLC Agreement are relevant to the present dispute.

a. Members and Interests

The LLC Agreement names Monsanto and STI as the Members of NSC, and provides that each Member shall have an Interest in NSC. The LLC Agreement defines "Interest" as "[a] Member's Percentage Interest, right to distributions under Section 4.1 of this Agreement, and any other rights which such Member has in the Company." A Member's Percentage Interest is determined according to the Member's capital contributions to NSC. Pursuant to the LLC Agreement, Monsanto contributed assets to NSC totaling \$ 162.9 million, and STI contributed assets totaling \$ 37.1 million, giving the firms an 81.5% and 18.5% Percentage Interest, respectively, in NSC. The LLC Agreement establishes procedures for Members to adjust their Percentage Interest in NSC.

b. Net Cash Flow and other distributions

The Members are entitled to receive distributions of Net Cash Flow and allocations [**6] of profits and losses. Net Cash Flow is defined, essentially, as all cash receipts of NSC, excluding members' capital contributions, less all cash expenditures, accrued expenses, and loan payments due. Section 4.1 of the LLC Agreement establishes the allocation mechanism by which Members receive distributions of Net Cash Flow, as follows:

Net Cash Flow shall be determined at such times and in such amounts as the Board, in its sole discretion, shall determine. Any Net Cash Flow so distributed shall be distributed to the Members in the following order: (i) first, the **preferred return** on any Optional Capital Contributions, pro rata in accordance with the relative amounts thereof; (ii) second, any Optional Capital Contributions not previously returned, pro rata in accordance with the relative amounts thereof; (iii) third, any Additional Capital Contributions not previously returned, pro rata in accordance with the relative amounts thereof; (iv) fourth, any Capital Contributions to the extent not previously returned, pro rata in accordance with the relative amounts thereof; and (v) fifth, to the Members, pro rata in accordance with their respective Percentage Interests.

The [**7] LLC Agreement also provides that NSC's income, profits, gains, losses, deductions, and credits shall be allocated to the Members pro rata in accordance with their respective Percentage Interests.

c. Board of Managers

The LLC Agreement provides that the business and affairs of NSC shall be managed by a Board of Managers. As noted above, the Board, in its sole discretion, shall determine the Net Cash Flow of NSC, and shall distribute the Net Cash Flow to the Members on a pro rata basis. Except as otherwise provided for in the LLC Agreement, the Board of Managers has exclusive authority to bind NSC, and to manage and control NSC's business and affairs. The LLC Agreement states:

Except as otherwise expressly set forth in this Agreement, the Members shall not have any authority, right, or power to bind the Company, or to manage or control, or to participate in the management or control of, the business and affairs of the Company in any manner whatsoever. Such management shall in every respect be the full and complete responsibility of the Board alone as provided in this Agreement.

The Members of NSC may remove the Managers with or without cause. [*379]

d. Members' voting [**8] rights

The Members of NSC are entitled to vote on certain matters, including on all incurrences of indebtedness or guarantees thereof. The LLC Agreement specifies that a Majority in Interest, which is defined as 51% of the Percentage Interests owned by the Members, is required to constitute a quorum, or to amend the LLC Agreement.

e. Transfer of Interests

The LLC Agreement restricts the ability of Members to transfer or otherwise dispose of their Interests in NSC absent consent of the Board. Moreover, Members are prohibited from disposing of their Interests in NSC when the disposition would cause NSC to be taxable as a corporation, would violate federal or state securities laws, or would violate other laws or commitments binding on NSC. In full, § 6.1(a) of the LLC Agreement provides:

No Member may sell, assign, transfer or otherwise dispose of, or pledge, hypothecate or otherwise encumber his Interest without the prior consent of the Board, and any such act in violation hereof shall be of no effect and shall not be binding on the Company. Anything contained herein to the contrary notwithstanding, no Member may sell, assign, transfer, encumber or otherwise dispose [**9] of his Interest if such disposition would (i) cause the Company to be treated as an association taxable as a corporation (rather than a partnership) for federal income tax purposes; (ii) violate the provisions of any federal or state securities laws; or (iii)

violate the terms of (or result in a default or acceleration under) any law, rule, regulation, agreement or commitment binding on the Company.

The LLC Agreement establishes procedures for assigning the whole or any portion of a Member's Interest to a Substituted Member.

B. The Sale of NSC

1. Solicitation of Great Lakes

In October 1998, BancBoston Robertson Stephens, an investment bank, prepared a Confidential Descriptive Memorandum (the "Offering Memorandum") on behalf of Monsanto and STI to promote the sale of NSC. The Offering Memorandum provides an overview of NSC's business, identifies potential growth opportunities and strategies for NSC, and reports NSC's financial performance. The Offering Memorandum recites that NSC's sales increased from \$ 8.3 million in 1995 to \$ 34.5 million in 1997, and projects that NSC's sales would increase to \$ 93.2 million in 1999 and \$ 192.2 million by 2002.

On November 10, 1998, Monsanto [**10] and STI presented the Offering Memorandum to Great Lakes, together with a letter from BancBoston Robertson Stephens proposing that final bids be submitted by year end. On November 12, 1998, Great Lakes responded to the solicitation with a letter indicating its interest in submitting a bid.

On December 11, 1998, Ian Wolpert, a Vice-President of Monsanto and the authorized representative of defendants, met with representatives from another interested bidder. Wolpert allegedly told the bidder's representatives that he stood behind the defendants' recently issued sales projections. After Wolpert made these remarks, Fred Beyerlein, the Co-Chief Operating Officer of NSC, allegedly spoke to Wolpert outside the meeting, taking exception to Wolpert's remarks, and voicing concern about the sales projections. Wolpert allegedly became angry, and advised Beyerlein that it was his job to be an active and enthusiastic participant in the sale process.

2. Changes in the Market for L-phe and Tic-D

In early 1999, as negotiations over the sale of NSC continued, a number of events were occurring that may have impacted the business prospects of NSC. [*380] Monsanto and other competing producers of L-phe, [**11] in particular the Korean firm Daesang, began discounting the sale price of L-phe in the sweetener market. As the price of L-phe dropped, NSC allegedly began experiencing diminished sales of L-phe, particularly to NSC's sole customer in the sweetener market, Enzymologa. Moreover, an Italian firm, Archimica, was producing Tic-D, a pharmaceutical intermediate derived from L-phe, by a manufacturing process that allegedly infringed the claims of a United States patent assigned to NSC. Archimica was allegedly selling Tic-D products to NSC's customers.

3. Great Lakes' Offer to Purchase NSC, and Monsanto's Revision of NSC's Financial Projections

On January 15, 1999, Wolpert provided representatives of Great Lakes with revised sales projections for NSC, reducing the forecast of \$ 93.2 million originally stated in the Offering Memorandum to \$ 78 million.

The following week, Great Lakes offered to acquire defendants' Interests in NSC for approximately \$ 130 million.

During the months of January through April 1999, Great Lakes conducted due diligence concerning NSC's business, intellectual property, its product markets, and its actual and projected sales. During these months, defendants [**12] allegedly instructed NSC's management not to speak directly to Great Lakes regarding sales, sales forecasts, customer orders and other information, telling NSC management, instead, that all such inquiries should be channeled to defendants' representatives who would respond to Great Lakes.

In February 1999, defendants allegedly informed NSC's management that defendants were considering ending negotiations with Great Lakes and seeking a new buyer. NSC's management allegedly told defendants that, in light of reduced sales in 1999, seeking a new buyer would necessitate a complete revision of the Offering Memorandum. Allegedly as a result of these communications, defendants continued negotiations with Great Lakes.

On March 15, 1999, during a teleconference call with Wolpert, representatives from Great Lakes raised concerns about defendants' sales projections for NSC. Wolpert allegedly replied that the reduced sales in 1999 were the result of temporary reductions in orders and the accelerated posting of 1999 sales in 1998, and that the shortfall in sales in the first quarter of 1999 would benefit Great Lakes because those deferred sales would be realized after Great Lakes acquired NSC. [**13]

On March 16, 1999, Monsanto and STI provided Great Lakes with revised financial projections, stating that NSC could realize total sales of approximately \$ 68.2 million in 1999. Defendants allegedly assured Great Lakes that NSC's total sales would increase to \$ 124.1 million in 2000, \$ 149.9 million in 2001, and \$ 184 million in 2002. At a meeting the same week between defendants and Great Lakes, Wolpert allegedly stated to Great Lakes' representative that defendants "stood by" these sales projections. After the meeting, Beyerlein allegedly told Wolpert that he, Beyerlein, did not stand behind the projections. Defendants allegedly prohibited Beyerlein from advising Great Lakes of his opinions.

In early April 1999, the parties adjusted the purchase price for NSC from \$ 130 million to \$ 125 million. On April 8, 1999, the parties entered into an Ownership Interest Purchase Agreement (the "Purchase Agreement"). On April 12, 1999, Wolpert executed the Purchase Agreement on behalf of defendants, and on April 14, Great Lakes

executed the Purchase Agreement. The parties closed the transaction on May 3, 1999.

4. The Purchase Agreement

a. Characterization of Interests as "equity securities" [**14]

In setting forth the sellers' representations and warranties, the Purchase Agreement [**381] refers to the Ownership Interests in NSC being transferred as "equity securities." In full, § 4.1(a) states:

Monsanto owns 31.6 percent of the Ownership Interests and STI owns 68.4 percent of the Ownership Interests, free and clear of any and all liens, encumbrances, restrictions and rights of any nature held by other persons. The Ownership Interests represent 100% of the issued and outstanding equity securities of the Company, all of which are owned by the Sellers and all of which have been duly authorized, are validly issued, fully paid, and nonassessable, and are held of record by the Sellers. There are no outstanding or authorized options, warrants, purchase rights, subscription rights, conversion rights, exchange rights or other contracts or commitments that obligate the Company to issue, sell, or otherwise cause to become outstanding any of its equity securities. There are no outstanding or authorized equity appreciation, phantom equity, or similar rights with respect to the Company. There are no voting trusts, proxies, or other agreements or understandings with respect to the voting [**15] of the equity securities of the Company.

b. Representation and warranty of NSC's financial position

In § 4.6 of the Purchase Agreement, Monsanto and STI make the representation and warranty that, except as otherwise provided, the financial statements provided by defendants to Great Lakes "reflect all material items and present fairly in all material respects the financial position of the Company as of the dates thereof and the results of operations for the periods described therein."

c. Representation and warranty as to lack of adverse changes

In § 4.7(a) of the Purchase Agreement, Monsanto and STI make the representation and warranty that, since December 31, 1998, "there has been no change in the business of the Company," which would have a "negative effect or negative change on the operations, results of operations or condition (financial or otherwise) in an amount equal to \$ 6,500,000 or more."

d. Responsibility of Great Lakes to evaluate NSC

The Purchase Agreement includes a disclaimer which states that Great Lakes is to take full responsibility for evaluating the accuracy of all estimates and projections furnished

to it by Monsanto and STI. Section 6.10 [**16] of the Purchase Agreement, in part, states:

In connection with the Buyer's investigation of the Company, the Buyer may have received from or on behalf of the Sellers certain projections, including projected statements of operating revenues and income from operations of the Company. The Buyer acknowledges that there are uncertainties inherent in attempting to make such estimates, projections and other forecasts and plans, that the Buyer is familiar with such uncertainties, that the Buyer is taking full responsibility for making its own evaluation of the adequacy and accuracy of all estimates, projections and other forecasts and plans so furnished to it (including the reasonableness of the assumptions underlying such estimates, projections and forecasts), and that the Buyer has received no representation or warranty from either Seller with respect to such estimates, projections and other forecasts and plans (including the reasonableness of the assumptions underlying such estimates, projections and forecasts).

e. Transaction Agreements

The Purchase Agreement provides that the parties shall enter into a number of Transaction Agreements prior to the closing of the Purchase [**17] Agreement, including a Supply Agreement, under which Monsanto would agree to continue to manufacture certain L-phe products for sale to NSC. Section 9 of the Supply Agreement, which was entered into on May 1, 1999, [*382] provides in pertinent part that Monsanto shall set aside on consignment "Safety Stock," which is defined as a quantity of identified L-phe products equal to one-sixth of the products shipped from Monsanto to NSC during the previous year.

f. Indemnification

Section 11.1 of the Purchase Agreement states that, except as otherwise provided, Monsanto and STI "will indemnify and reimburse the Buyer for any and all claims, losses, liabilities, damages, penalties, fines, costs and expenses . . . incurred by the Buyer and its Affiliates" as a result of, among other things, any breach or inaccuracy of any representation or warranty made by Monsanto or STI as set forth in the Purchase Agreement.

C. The Dissolution of NSC

On October 5, 1999, Great Lakes filed a Certificate of Cancellation with the State of Delaware, dissolving NSC as a separate entity. NSC's actual sales for 1999 were approximately \$ 33 million, less than 50% of the projections provided by Monsanto and STI [**18] to Great Lakes in March 1999.

D. The Lawsuit

1. Great Lakes' Complaint

On January 20, 2000, Great Lakes filed an eight count complaint in this court. Count I asserts that Monsanto and STI violated § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, by making material misrepresentations and by failing to disclose material facts in connection with the sale of securities. Count II asserts that Monsanto and STI violated Indiana securities law, § 23-2-1-1 et seq., by making material misrepresentations and by failing to disclose material facts in conjunction with the sale of securities. Count III asserts that Monsanto and STI engaged in common law fraud by knowingly or recklessly making material misrepresentations and failing to disclose material facts in conjunction with the sale of NSC. Count IV asserts that Monsanto and STI fraudulently induced Great Lakes to purchase NSC. Count V asserts that Monsanto and STI breached their warranties and representations given in § 4.7 of the Purchase Agreement, as NSC had sustained adverse changes to its business in excess of \$ 6.5 [**19] million between December 31, 1998 and April 30, 1999. Count VI asserts that Monsanto and STI breached the Supply Agreement by failing to supply NSC with a quantity of Safety Stock of certain L-phe products. Count VII asserts that Monsanto and STI breached their representations and warranties that the financial statements of NSC fairly represented NSC's financial position. Count VIII asserts that Great Lakes is entitled to indemnification for all damages and claims arising out of the breach or inaccuracy of any representation or warranty of the defendants as set forth in the Purchase Agreement.

As to Counts I and III, Great Lakes seeks compensatory damages in excess of \$ 58 million, plus costs, fees, and prejudgment interest. As to Counts II and IV, Great Lakes seeks to rescind the Purchase Agreement and to recover \$ 125 million as the full amount paid by Great Lakes for the Interest in NSC, plus costs, fees, and prejudgment interest, or to recover compensatory damages in excess of \$ 58 million plus costs, fees, and prejudgment interest. As to Count VI, Great Lakes seeks a declaratory judgment that Monsanto is in breach of the Supply Agreement and an order for specific performance [**20] under the Supply Agreement, or an award of consequential damages. As to Count VII, Great Lakes seeks an award of compensatory damages in excess of \$ 680,000, plus costs, fees, and prejudgment interest. As to Counts V and VIII, Great Lakes seeks an award of indemnified damages in the aggregate sum of \$ 13 million for its attorneys' fees and costs of suit. As to Counts III, IV, and V, Great Lakes seeks an award of punitive damages and fees.

Great Lakes asserts that this court has subject matter jurisdiction over its federal [*383] securities law claim, pursuant to 28 U.S.C. § 1331, and pendent jurisdiction over its state law and common law claims.

2. Defendants' Motion to Dismiss

On March 9, 2000, Monsanto and STI moved to dismiss the complaint pursuant to Fed. R. Civ. P. 9(b) and 12(b)(6) for failure to plead fraud with specificity and for failure to state a claim upon which relief may be granted. Monsanto and STI assert that Great

Lakes' federal and state securities claims fail as a matter of law because the Interests in NSC transferred pursuant to the Purchase Agreement do not constitute "securities" under federal or state law, and because plaintiffs fail to [**21] adequately plead fraud. Monsanto and STI argue that if plaintiff's federal securities claim is dismissed, plaintiff's state law claims should be dismissed for lack of supplemental jurisdiction. Monsanto and STI argue, moreover, that all plaintiffs' state law claims, with the exception of Count VII, also fail as a matter of law.

II. DISCUSSION

A. What Is an LLC?

In Delaware, LLCs are formed pursuant to the Delaware Limited Liability Company Act, 6 Del. C. § 18-101 et seq. LLCs are hybrid entities that combine desirable characteristics of corporations, limited partnerships, and general partnerships. LLCs are entitled to partnership status for federal income tax purposes under certain circumstances, which permits LLC members to avoid double taxation, i.e., taxation of the entity as well as taxation of the members' incomes. See Treas. Reg. § 301.7701-1 et seq. Moreover, LLCs members, unlike partners in general partnerships, may have limited liability, such that LLC members who are involved in managing the LLC may avoid becoming personally liable for its debts and obligations. See 6 Del. C. § 18-303. In addition, LLCs have greater flexibility than corporations [**22] in terms of organizational structure. The Delaware Limited Liability Company Act, for example, establishes the default rule that management of an LLC shall be vested in its members, but permits members to establish other forms of governance in their LLC agreements. See 6 Del. C. § 18-402.

The following law review articles provide additional commentary on the characteristics of LLCs: Michael J. Garrison & Terry W. Kneopfle, Limited Liability Company Interests as Securities: A Proposed Framework for Analysis, 33 Am. Bus. L.J. 577 (1996); Park McGinty, The Limited Liability Company: Opportunity for Selective Securities Law Deregulation, 64 U. Cin. L. Rev. 369 (1996); Carol R. Goforth, Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage This Result, 45 Hastings L.J. 1223 (1994); and Mark A. Sargent, Are Limited Liability Company Interests Securities?, 19 Pepp. L. Rev. 1069 (1992).

B. Are the Interests in NSC That Were Transferred Pursuant to the Purchase Agreement "Securities" Under Federal Law?

To prevail in its claim that defendants engaged [**23] in securities fraud under § 10(b) of the Securities Exchange Act of 1934, Great Lakes must demonstrate that: (i) defendants made a misstatement or omission; (ii) of a material fact; (iii) with scienter; (iv) in connection with the purchase or sale of securities; (v) upon which plaintiffs relied; and (vi) that reliance proximately caused plaintiffs' losses. See *In re Westinghouse Securities Litigation*, 90 F.3d 696, 710 (3d Cir. 1996). A threshold

question in this matter is whether defendants' alleged misconduct involved a purchase or sale of securities. Defendants contend that plaintiff's claim fails as a matter of law because the Interests in NSC do not constitute securities.

Section 2(1) of the Securities Act of 1933 lists **financial instruments** that qualify as securities, as follows:

The term "security" means any note, stock, treasury stock, bond, debenture, [*384] evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting- trust certificate, certificate of deposit for a security, fractional undivided [**24] interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(a)(1). Among the securities enumerated in § 2(1) of the Securities Act, Great Lakes contends that the Interests in NSC constitute either "stock," an "investment contract," or "any interest or instrument commonly known as a 'security.'"

1. Key Cases Governing the Characterization of Novel Instruments

It is helpful, before determining whether the Interests in NSC constitute "stock," an "investment contract," or "any interest or instrument commonly known as a security," to review a series of cases that provide guidance as to [**25] how to characterize novel **financial instruments**.

a. SEC v. W.J. Howey

The Supreme Court defined the parameters of an "investment contract" for the purposes of federal securities law in the case of SEC v. W.J. Howey Co., 328 U.S. 293, 298, 90 L. Ed. 1244, 66 S. Ct. 1100 (1946). Howey concerned a Florida corporation, the Howey Company, that sold small tracts of land in a citrus grove to forty-two purchasers, many of whom were patrons of a resort hotel. See *id.* at 296. For the most part, the purchasers lacked the knowledge, skill, and equipment necessary for the care and cultivation of citrus trees. They invested in the enterprise for profit. The purchasers were free to contract with a number of companies to service the tracts, but the sales contract stressed the superiority of Howey-in-the-Hills Service, Inc., which the purchasers chose to service 85% of the acreage sold. The service contracts granted Howey-in-the-Hills full and complete possession of the acreage, and the individual purchasers had no right of

entry to market the crop. Purchasers of tracts shared in the profits of the enterprise, which amounted to 20% in the 1943-44 growing [**26] season. The Howey Company did not register the interests in the enterprise as securities.

The Securities and Exchange Commission ("SEC") brought an action pursuant to § 5(a) of the Securities Act, 15 U.S.C. § 77e(a), seeking to enjoin the Howey Company from using interstate mail to offer and sell interests in the enterprise. Because the interests at issue did not constitute any of the traditional kinds of securities enumerated in § 2(1) of the Securities Act, the SEC argued that the interests were "investment contracts."

Noting that the term "investment contract" was not defined by Congress, but that the term was widely used in state securities laws, the Court largely adopted the definition used at the time by state courts. The Court stated that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *Howey*, 328 U.S. at 298-99. Thus, the three requirements for establishing an investment contract are: (1) "an investment of money," (2) "in a common enterprise, [**27]" (3) "with profits to come solely from the efforts of others." *Id.* at 301. In articulating this test, the Supreme Court stated that this definition [*385] "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299.

b. *United Housing Foundation, Inc. v. Forman*

The Supreme Court established guidelines for whether non-traditional instruments labeled "stock" constitute securities in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 44 L. Ed. 2d 621, 95 S. Ct. 2051 (1975). *Forman* concerned a nonprofit housing cooperative that sold shares of "stock" to prospective tenants. The sole purpose of acquiring the shares was to enable the purchaser to occupy an apartment in the cooperative. The shares essentially represented a recoverable deposit on the apartment. The shares were explicitly tied to the apartment, as they could not be transferred to a non-tenant. Nor could they be pledged or encumbered. No voting rights attached to the shares.

After the housing cooperative [**28] raised rental charges, the residents sued the cooperative under § 17(a) of the Securities Act, 15 U.S.C. § 77q(a), asserting that the cooperative falsely represented that it would bear all subsequent cost increases due to factors such as inflation. The Supreme Court held that the "stock" issued by the cooperative did not constitute a security. The shares, the Court found, lacked the five most common features of stock: (1) the right to receive dividends contingent upon an apportionment of profits; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) voting rights in proportion to the number of shares owned; and (5) the ability to appreciate in value. *Id.* at 851. Finding that the purchasers obtained the shares in order to acquire subsidized low-cost living space, not to invest for profit, the Court ruled that the "stock" issued by the cooperative was not a security. See *id.* at 852.

c. Landreth Timber Co. v. Landreth

Following the issuance of Forman, a number of lower courts began to apply the Howey test to distinguish between investment transactions, which were covered by the securities laws, and [**29] commercial transactions, which were not. See, e.g., Landreth Timber Co. v. Landreth, 731 F.2d 1348, 1352 (9th Cir. 1984) (citing cases). In Landreth, the Ninth Circuit addressed whether a single individual who purchased 100% of the stock in a lumber corporation, and who had the power to actively manage the acquired business, could state a claim under the securities laws for alleged fraud in the sale of the business. The Ninth Circuit found that the purchaser bought full control of the corporation, and that the economic reality of the transaction was the purchase of a business, and not an investment in a security. See *id.* at 1353. The court held that the sale of 100% of the stock of a closely held corporation was not a transaction involving a "security."

Reversing the Ninth Circuit, the Supreme Court reasoned that it would be burdensome to apply the Howey test to transactions involving traditional stock. See Landreth Timber Co. v. Landreth, 471 U.S. 681, 686-88, 85 L. Ed. 2d 692, 105 S. Ct. 2297 (1985). The Court held that, insofar as a transaction involves the sale of an instrument called "stock," and the stock bears the five [**30] common attributes of stock enumerated in Forman, the transaction is governed by the securities laws. The Court noted that stock is specifically enumerated in § 2(1) of the Securities Act as a security, and that stock is so "quintessentially a security" that it is unnecessary to apply the Howey test to determine if it is a security. *Id.* at 693. The **financial instrument** involved in the case, the Court reasoned, "is traditional stock, plainly within the statutory definition." *Id.* at 690. "There is no need here," the Court continued, "to look beyond the characteristics of the instrument to determine whether the [Securities] Acts apply." *Id.* The Court stated [**386] that the Howey test should only be applied to determine whether an instrument is an "investment contract," and should not be applied in the context of other instruments enumerated in § 2(1) of the Securities Act. See *id.* at 691-92.

d. Penturelli v. Spector, Cohen, Gordon & Rosen

In Penturelli v. Spector, Cohen, Gordon & Rosen, 779 F.2d 160 (3d Cir. 1985), the Third Circuit reaffirmed that the Howey test should not be used to determine whether [**31] instruments that are enumerated in the Securities Act constitute securities. In Penturelli, an individual, Bernardo Penturelli, purchased 28 fractional undivided working interests in a coal mining operation. Penturelli relied on the advice of his accountant that purchasing the interests would result in significant tax benefits. The accountants and other parties connected with the mining operations allegedly diverted Penturelli's funds to mine worthless land, and the tax benefits never materialized. Penturelli brought suit under 15 U.S.C. § 10(b).

The district court found that Penturelli exercised managerial control over the mining operations, and dismissed the complaint because Penturelli was not a sufficiently passive investor under the Howey test. The Third Circuit reversed. Noting that

fractional undivided interests in mining operations are listed as securities in § 2(1) of the Securities Act, the court reasoned that under Landreth, it was unnecessary to apply the Howey test. See *id.* at 164-65.

2. Prior Cases Concerning Whether Interests in LLCs are Securities

The present case raises novel issues regarding the regulation [**32] of transactions involving interests in LLCs. The court has identified three cases in which other courts have determined whether interests in LLCs constitute securities.

a. *Keith v. Black Diamond Advisors, Inc.*

In *Keith v. Black Diamond Advisors, Inc.*, 48 F. Supp. 2d 326 (S.D.N.Y. 1999), the plaintiff, Keith, founded a sub-prime mortgage lending firm, Eagle Corp., and brought it to profitability. Milton was an original investor in Eagle. Black Diamond, a venture capital firm, proposed a joint venture in which it would contribute \$ 150,000 in cash, and Keith and Milton would each contribute their interests in Eagle, to form a New York limited liability company, Pace LLC. Through this transaction, Black Diamond acquired 50% of the interests in Pace, and Keith and Milton each received a 25% stake. Keith alleged that Black Diamond subsequently used its majority position to strip him of control of Pace. Keith sued Black Diamond for federal securities fraud.

The court applied the Howey test, and found that Keith had invested money in a common enterprise. The court, however, found that Keith had retained substantial control over the enterprise, such that he did not [**33] have an expectation of profits "solely from the efforts of others." As such, the court concluded that the LLC interests were not investment contracts. The court dismissed the case for lack of jurisdiction.

b. *SEC v. Parkersburg Wireless LLC*

SEC v. Parkersburg Wireless LLC, 991 F. Supp. 6 (D.D.C. 1997), involves a LLC that was established to provide wireless cable services. The promoters of the company sold "memberships" in the company to over 700 individuals in 43 states. The promoters targeted prospective investors who had Individual Retirement Accounts, and encouraged them to divert funds from their IRAs to buy membership units of the company.

The SEC sought to enjoin the sale of the membership interests. The court found that the interests sold in the LLC "easily satisfy" the Howey test for investment contracts. The investors' \$ 10,000 minimum [*387] contribution constituted an "investment of money." Because the 700 individuals were to receive a pro rata share of the company's revenues, the court found there was a common enterprise. Moreover, the investors had little, if any, input into the company, so their profits were to come solely from the efforts of others. [**34]

c. *SEC v. Shreveport Wireless Cable Television Partnership*

SEC v. Shreveport Wireless Cable Television Partnership, 1998 WL 892948 (D.D.C. 1998), involves three entities: Reading Partnership and Shreveport Partnership, which are both general partnerships, and Baton Rouge LLC. All three entities were established to provide wireless cable services. Each entity engaged the services of a corporation to develop the telecommunications services and to solicit public investment in the enterprises. The promoters sold memberships in the three entities to approximately 2000 investors.

The SEC sought to enjoin the sale of interests in the ventures. In ruling upon defendants' motion for summary judgment that the interests were not securities, the court applied the Howey test to determine whether the interests were investment contracts. The court found that the purchasers of the interests had invested money in a common enterprise. The court found, however, that there was a question of fact as to whether the investors exercised significant control over the management of the corporation, and denied defendants' motion for summary judgment.

Having reviewed these other cases [**35] in which courts have considered whether LLC interests might constitute securities, the court will determine whether the Interests in NSC constitute "stock," an "investment contract," or "any interest or instrument commonly known as a security."

3. Are the Interests In NSC "Stock"?

Great Lakes contends that NSC is the functional equivalent of a corporation, and that the Interests in NSC should be treated as stock. Great Lakes notes that the LLC Agreement refers to the Interests as "equity securities," and that the LLC Agreement prohibits the transfer of the Interests in such a way as would "violate the provisions of any federal or state securities laws."

Monsanto and STI, on the other hand, contend that the Interests cannot be stock because NSC is not a corporation.

As discussed above, the Supreme Court has described the five most common characteristics of stock as follows: (1) the right to receive dividends contingent upon an apportionment of profit; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) the conferring of voting rights in proportion to the number of shares owned; and (5) the capacity to appreciate in value. See *Landreth*, 471 U.S. at 686; [**36] *Forman*, 421 U.S. at 851.

As noted by plaintiffs, these attributes of stock also characterize, at least to some degree, the Interests in NSC. NSC's Members are entitled to share, pro rata, in distributions of Net Cash Flow, contingent upon its distribution by the Board of Managers. The Interests are negotiable and may be pledged or hypothecated, subject to approval by the Board of Managers. See *Sulkow v. Crosstown Apparel Inc.*, 807 F.2d 33, 37 (2d Cir. 1986) (stating that some limitations on a stock's negotiability and

pledgeability are insufficient to negate the character of the stock as a security). Members in NSC have voting rights in proportion to their Percentage Interest in the company. And, the Interests in NSC have the capacity to appreciate in value. The Interests in NSC are undoubtedly stock-like in character, but the question remains if the Interests can be characterized as "stock" for the purposes of the federal securities laws.

The primary goal of the securities laws is to regulate investments, and not commercial ventures. See *Howey*, 328 U.S. at 298 (restricting [*388] scope of "investment contracts" to those enterprises with [**37] passive investors); *Reves v. Ernst & Young*, 494 U.S. 56, 64-65, 108 L. Ed. 2d 47, 110 S. Ct. 945 (1989) (articulating "family resemblance test" to distinguish between notes that are used in the investment market from those having commercial character). In transactions involving traditional stock, lower courts had attempted to distinguish between investment transactions and commercial transactions. See *Landreth*, 731 F.2d at 1352. The Supreme Court, as discussed above, held that it is unnecessary to attempt to distinguish between commercial and investment transactions when the **financial instrument** in question is traditional stock. See *Landreth*, 471 U.S. at 690. Because stock is listed in § 2(1) of the Securities Act as a security, and because people trading in traditional stock are likely to have a high expectation that their activities are governed by the securities laws, the Court ruled that all transactions involving traditional stock are covered by the securities laws, regardless if the transaction is of an investment or commercial character. See *id.* The Court expressly limited this rule to transactions involving traditional [**38] stock. See *id.* at 694.

The Supreme Court suggested, prior to the issuance of *Landreth*, that certain stock-like instruments might be construed as "stock" for the purposes of the federal securities laws. In *Tcherepnin v. Knight*, 389 U.S. 332, 19 L. Ed. 2d 564, 88 S. Ct. 548 (1967), the Court considered whether purchasers of withdrawable capital shares in a savings and loan association could state a claim under the federal securities laws for allegedly misleading statements made in solicitation materials. Holders of the withdrawable capital shares were entitled to be members of the association and were granted voting rights in proportion to the number of shares they owned. The holders were entitled to dividends declared by the association's board of directors and based on the association's profits. Certain restrictions applied to the transferability of the instruments. The Court rejected the lower court's finding that the restrictions on negotiability precluded a finding that the shares were securities. The Court ruled that the instruments constituted "investment contracts" under *Howey*. See *id.* at 339. The Court continued, stating [**39] that the instruments could also be characterized as "certificates of interest or participation in any profit-sharing agreement," as "transferable shares," or as "stock." *Id.* at 339-40. The Court held that the holders of withdrawable capital shares were entitled to the protections afforded by the securities laws.

In *Marine Bank v. Weaver*, 455 U.S. 551, 557, 71 L. Ed. 2d 409, 102 S. Ct. 1220 (1982), the Court reaffirmed its holding in *Tcherepnin* that the withdrawable capital shares in that case were "like ordinary shares of stock." This statement arose in the context of a suit brought by holders of certificates of deposit who were allegedly

defrauded into pledging their certificates to guaranty a third party loan. The lower court held that the certificates of deposit were securities, as they were deemed to be the functional equivalent of the withdrawable capital shares at issue in *Tcherepnin*. See 88 S. Ct. at 557. The Court found that the certificates of deposit had different characteristics than withdrawable capital shares, as they conferred upon their holders the right to a fixed rate of interest and did not entitle holders to voting [**40] rights. The Court found that the certificates of deposit were not securities.

Although, in *Tcherepnin*, the Supreme Court found that stock-like instruments could be deemed "stock" for the purposes of federal securities law, this court does not find *Tcherepnin* controlling in the present case. *Tcherepnin* preceded *Landreth*, which holds that the per se rule announced in that case should apply only to transactions involving traditional stock, because the name "stock" serves to put parties on notice that the transaction is governed by the securities laws. See *Landreth*, 471 U.S. at 690. [*389] Moreover, the withdrawable capital shares at issue in *Tcherepnin* were clearly investment instruments, and there is no indication that the holding in that case would apply to stock-like instruments used in commercial ventures. See *Tcherepnin*, 389 U.S. at 339. Although the Court subsequently reiterated in *Marine Bank* that the withdrawable capital shares in *Tcherepnin* were "stock-like," see *Marine Bank*, 455 U.S. at 557, the Court did so in order to distinguish certificates of deposit from other instruments deemed to be securities, [**41] and did not appear to hold that all "stock-like" instruments should be regulated as securities.

In the present case, the LLC Interests, although they are "stock-like" in nature, are not traditional stock. *Landreth*, thus, is inapplicable to this case, and the court must determine whether the sale of NSC was essentially an investment transaction, in which case the securities laws apply, or whether it was a commercial transaction, in which case they do not. To make this determination, the court will apply the *Howey* test for investment contracts. See *Landreth*, 471 U.S. at 691-92; see also *Keith v. Black Diamond Advisors, Inc.*, 48 F. Supp. 2d 326 (S.D.N.Y. 1999) (dismissing securities fraud complaint after applying only the *Howey* test to determine whether interests in an LLC were securities). The court will also consider whether the Interests can be characterized as "any interest or instrument commonly known as a security."

4. Are the Interests in NSC an "Investment Contract"?

As stated above, to constitute an "investment contract," the instruments purchased by Great Lakes must involve: (1) "an investment of money," (2) "in a common enterprise," [**42] " (3) "with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301. The parties do not dispute that the first prong of the *Howey* test--an investment of money--is satisfied by the facts of this case. The court will now consider whether Great Lakes invested in a "common enterprise," and whether Great Lakes' profits in NSC were to come "solely from the efforts of others."

a. Did Great Lakes invest in a "common enterprise"?

Monsanto and STI argue that Great Lakes' purchase of the Interests in NSC fails the second prong of the Howey test, which requires that an investor invest its money in a "common enterprise." According to defendants, Great Lakes bought the entirety of NSC without pooling its contributions with those of other investors.

Great Lakes, on the other hand, contends that when Monsanto and STI created NSC, they pooled their resources and established NSC as a common enterprise. At the time of sale of the membership Interests, Great Lakes contends, the Interests were securities, and they did not cease to be securities when they were transferred to Great Lakes.

To determine whether a party has invested funds in a common enterprise, [**43] courts look to whether there is horizontal commonality between investors, or vertical commonality between a promoter and an investor. Horizontal commonality requires a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors. *Steinhardt Group Inc. v. Citicorp.*, 126 F.3d 144, 151 (3d Cir. 1997). The vertical commonality test is less stringent, and requires that an investor and promoter be engaged in a common enterprise, with the "fortunes of the investors linked with those of the promoters." *Securities and Exchange Commission v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125, 1130 (9th Cir. 1991); *Securities and Exchange Commission v. Professional Associates*, 731 F.2d 349, 354 (6th Cir. 1984). The Third Circuit has applied the horizontal commonality approach, see *Salcer v. Merrill Lynch, Pierce, Fenner and Smith Inc.*, 682 F.2d 459, 460 (3d Cir. 1982), but has subsequently indicated that the vertical commonality test might [*390] be applicable in other cases, see *Steinhardt*, 126 F.3d at 152.

In this case, Great Lakes bought 100% of the Interests of NSC [**44] from Monsanto and STI. Great Lakes, accordingly, did not pool its contributions with those of other investors, as is required for horizontal commonality. After the sale, Monsanto and STI retained no interest in NSC, so it cannot be said that the fortunes of Great Lakes were linked to those of defendants, as is required for vertical commonality.

Great Lakes urges that when the Interests in NSC were created, Monsanto and STI pooled their contributions in a common enterprise. Great Lakes contends that Monsanto's and STI's Interests were securities when they were created, and that they did not cease to be securities when conveyed to Great Lakes. In support of this proposition, Great Lakes relies on *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

Great Western involves a company, Artko, that obtained a line of credit from a bank and executed an interest-bearing, unsecured promissory note to the bank. The bank allegedly relied on considerable financial data prepared by Artko before extending the line of credit. After the bank did not receive payment on the note, it sought recovery from Artko's president under § 17(a) of the Securities Act, 15 U.S.C. § 77q [**45] (a). The question before the court was whether the promissory note constituted a security. Although "notes" are included in the statutory definition of a security, 15 U.S.C. § 77b(a)(1), the court recognized that not all notes are securities. See *Great Western*, 532

F.2d at 1256 (citing cases). The court inquired whether the bank had contributed "risk capital" subject to the "entrepreneurial or managerial efforts" of Artko, as would support a finding that the note was a security. See *id.* at 1257. The court stated that the circumstances of issuance of the note, rather than how the proceeds of the line of credit were used, were determinative of the character of the note. See *Great Western*, 532 F.2d at 1258. *Great Western* reaffirms the principle that the character of a **financial instrument** is determined by the terms of its offer, the plan of its distribution, and the economic inducements held out to potential purchasers. See *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53, 88 L. Ed. 88, 64 S. Ct. 120 (1943). *Great Western* does not draw into question the principle that courts are to **[**46]** look at the specific transaction at issue to determine whether the interests being transferred are securities. See *Steinhardt*, 126 F.3d at 153.

In this case, the challenged transaction is the sale of NSC by defendants to Great Lakes, and not the formation of NSC. Thus, the fact that Monsanto and STI pooled their contributions in the formation of NSC does not change the character of the sale of NSC to Great Lakes. The court concludes that Great Lakes did not invest in a common enterprise.

b. Were Great Lakes' Profits in NSC To Come "Solely from the Efforts of Others"?

Monsanto and STI argue that the profits in NSC did not come solely from the efforts of others, as would support a finding that the Interests in NSC were securities. *Howey*, 328 U.S. at 298-99. Rather, defendants contend that Great Lakes had the power to control NSC through its authority to remove managers with or without cause, and to dissolve the entity.

Great Lakes argues, on the other hand, that it depended solely on the efforts of others to profit from NSC, as the LLC Agreement provides that the Members would retain no authority, right, or power to manage or control the operations of the **[**47]** company. In the alternative, Great Lakes contends that the *Howey* test does not apply to the sale of 100% of a business over which the purchaser intended to exercise control. **[*391]**

i. profits solely from the efforts of others

There is little caselaw establishing guidelines for determining whether a member in an LLC is sufficiently passive that he is dependent solely on the efforts of others for profits. In the context of general partnerships and limited partnerships, by contrast, there has been extensive litigation on whether partnership interests may qualify as securities. An analogy to partnership law is convenient for analyzing interests in LLCs, but there are important differences between general partnerships, limited partnerships, and LLCs.

General partnerships in Delaware are formed pursuant to the Delaware Revised Uniform Partnership Act, 6 Del. C. § 15-101 et seq. Each partner has equal rights in the management and conduct of the partnership business and affairs. 6 Del. C. § 15-401(f). In general, all partners are liable jointly and severally for all obligations of the

partnership. 6 Del. C. § 15-306(a). Because partners have equal rights in the management of general [**48] partnerships, and because they are not protected by limited liability, courts consistently state that partners in general partnerships are unlikely to be passive investors who profit solely on the efforts of others. Some courts have adopted per se rules that partnership interests are not securities. See, e.g., *Goodwin v. Elkins & Co.*, 730 F.2d 99, 107 (3d Cir. 1983). Other courts have adopted a presumption that partnership interests are not securities, but permit a finding that partnership interests are securities when a partner has so little control over the management as to be a passive investor. See *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981).

Limited partnerships in Delaware are formed pursuant to 6 Del. C. § 17-101 et seq. Limited partnerships are comprised of general partners and limited partners. General partners in limited partnerships have all the powers and duties of general partners in general partnerships, and are liable for the debts of the partnership. 6 Del. C. § 17-403(b). Limited partners have limited liability, but become liable as general partners if they take part in the control of the business. See 6 Del. [**49] C. § 17-303(a); *Unif. Ltd. Partnership Act* (1916) § 7, 6A U.L.A. 336 (1995). A limited partner may advise a general partner with respect to the business of the limited partnership, or cause a general partner to take action by voting or otherwise, without losing his limited liability. See 6 Del. C. § 17-303(b)(2). In cases involving transactions of interests in limited partnerships, wherein the limited partners exercised no managerial role in the partnership's affairs, courts treat the limited partners as passive investors, and find that the membership interests of limited partners constitute securities under federal law. See, e.g., *Mayer v. Oil Field Systems Corp.*, 721 F.2d 59, 65 (2d Cir. 1983). Where, however, a limited partner is found to have exercised substantial control over the management of the partnership, courts find that the limited partner has not profited solely from the efforts of others, and rule that the interest in the partnership is not a security. See, e.g., *Steinhardt*, 126 F.3d at 153.

Membership interests in LLCs are distinct from interests in general partnerships and limited partnerships. The primary differences between [**50] LLCs and general partnerships are that members of LLCs are entitled to limited liability, and, depending on the terms of the operating agreement giving rise to the particular LLC at issue, the members of the LLC may be less involved in the management of the enterprise than partners in a general partnership. As such, the grounds for creating a per se rule, or at least a presumption, that interests in general partnerships are not securities are lacking in the context of LLCs.

In comparison with limited partnerships, the Delaware Limited Liability Company Act permits a member in an LLC to be an active participant in management and still [*392] to retain limited liability. 6 Del. C. § 18-303. Thus, there is no statutory basis, as with limited partnerships, to presume that LLC members are passive investors entitled to protection under the federal securities laws.

The Delaware Limited Liability Company Act grants parties substantial flexibility in

determining the character of an LLC. Accordingly, the terms of the operating agreement of each LLC will determine whether its membership interests constitute securities. The presumptions that courts have articulated with respect to general partnerships [**51] and limited partnerships do not apply to LLCs. Rather, to determine whether a member's profits are to come solely from the efforts of others, it is necessary to consider the structure of the particular LLC at issue, as provided in its operating agreement.

In the present case, the Members of NSC had no authority to directly manage NSC's business and affairs. Section 5.1(a) of the LLC Agreement states:

Except as otherwise expressly set forth in this Agreement, the Members shall not have any authority, right or power to bind the Company, or to manage or control, or to participate in the management or control of, the business and affairs of the Company in any manner whatsoever. Such management shall in every respect be the full and complete responsibility of the Board alone as provided in this Agreement.

The Members, however, had the power to remove any Manager with or without cause, and to dissolve the company. Great Lakes exercised this authority on October 5, 1999, when it filed a Certificate of Cancellation with the State of Delaware, dissolving NSC as a separate entity. Moreover, Great Lakes' complaint avers that, prior to selling NSC, Monsanto and STI had the power [**52] to control the actions of the Managers, insofar as defendants allegedly prohibited NSC's management from speaking directly with Great Lakes regarding sales, sales forecasts, and customer orders.

The powers held by Great Lakes in NSC are comparable to those discussed in *Steinhardt*, 126 F.3d at 154, wherein the Third Circuit considered whether a limited partner in a limited partnership could state a claim under the securities laws. The limited partner, *Steinhardt*, purchased a 98.8% interest in the limited partnership, which acquired title to non-performing mortgage loans. The court noted that limited partners generally are passive investors entitled to protection under federal securities law. Upon analyzing the governance of the limited partnership at issue, however, the court found that *Steinhardt* alone constituted a "Majority of the Partners," and that *Steinhardt* was free to remove and replace the general partner without notice if the general partner refused to carry out *Steinhardt*'s proposals. See *id.* at 154. In light of this factor and others, the court found that the limited partnership agreement at issue gave *Steinhardt* significant powers that [**53] directly affected the profits it received from the partnership. Accordingly, the court concluded that *Steinhardt* was not a passive investor, and that *Steinhardt*'s membership in the partnership did not qualify as an investment contract.

The powers held by Great Lakes were comparable to those of *Steinhardt*, in that Great Lakes had the authority to remove NSC's managers without cause. Because Great Lakes was the sole owner of NSC, its power to remove managers was not diluted by the presence of other ownership interests. See *Williamson*, 645 F.2d at 423 (noting that a partner in a general partnership might be deemed to be a passive investor if there were a

sufficient number of other partners to dilute the partner's voting rights). Great Lakes' authority to remove managers gave it the power to directly affect the profits it received from NSC. Thus, the court finds that Great Lakes' profits from NSC did not come solely from the efforts of others. See *Howey*, 328 U.S. at 299. [*393]

ii. sale of 100% of a business

Alternatively, Great Lakes argues that, even if it did exercise substantial control over NSC, the transfer of Interests in NSC is nonetheless covered by the securities laws, because it bought 100% of the Interests in NSC and intended to operate the business. Great Lakes relies on *Landreth*, 471 U.S. at 681, in support of this proposition.

Under *Landreth*, as discussed above, a stock transaction is covered by the securities laws even though the purchaser exercises control over the acquired corporation. See *id.* at 690. *Landreth*, however, is applicable only to those cases involving stock, or other **financial instruments** which are listed in § 2(1) of the Securities Act. See *id.* When the **financial instrument** in question is a less traditional instrument that is not enumerated in the statute, but that might qualify as an "investment contract," then the complainant must demonstrate that the instrument satisfies the *Howey* test. As discussed above, the Interests in NSC do not constitute stock, and so *Landreth* is inapplicable.

The court finds that Great Lakes did not invest in a common enterprise, and did not have an expectation of profits "solely from the efforts of others," as is required by *Howey*. The Interests in NSC, thus, are not investment contracts.

5. Are the Interests in NSC "Any Interest [**55] or Instrument Commonly Known as a Security"?

Great Lakes argues that, even if the Interests in NSC do not otherwise satisfy the *Howey* test for investment contracts, they should be deemed to be "any interest or instrument commonly known as a security," as provided for in § 2(1) of the Securities Act. Great Lakes notes that the LLC Agreement refers to the Interests at issue as "equity securities," and that the LLC Agreement prohibits the transfer of the Interests in such a way as would "violate the provisions of any federal or state securities laws." Moreover, Great Lakes contends, ten states have defined interests in LLCs as securities, including Indiana, where NSC has its principal place of business.

Monsanto and STI contend that the Interests cannot be an "interest or instrument commonly known as a security," because the Interests in NSC do not satisfy the *Howey* test.

The Supreme Court has indicated that the term "any interest or instrument commonly known as a security" covers the same **financial instruments** as referred to by the term "investment contract." In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 44 L. Ed. 2d 621, 95 S. Ct. 2051 (1975), [*56] the Court stated that "we perceive no

distinction, for present purposes, between an 'investment contract' and an 'instrument commonly known as a 'security.' In either case, the basic test for distinguishing the transaction from other commercial dealings is 'whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.'" Id. at 852 (quoting *Howey*, 328 U.S. at 301); see also *Landreth*, 471 U.S. at 692 n.5 (same). The *Howey* test, the Court explained, "embodies the essential attributes that run through all of the Court's decisions defining a security." *Forman*, 421 U.S. at 852.

When confronted with novel **financial instruments**, numerous courts have considered whether to distinguish between an "investment contract" and "any interest or instrument commonly known as a security," and have declined to do so. See, e.g., *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1282 (S.D. Ohio 1996) (declining to find that swaps constitute an "interest or instrument commonly known as a security"); *Crabtree Investments, Inc. v. Aztec Enterprises, Inc.*, 483 F. Supp. 211, 215 (M.D. La. 1980) [****57**] (declining to find that a continuing guaranty to secure loans was an "interest or instrument commonly known as a security"). In this case, too, the court finds that it would be [***394**] improper to extend the definition of a security by reinterpreting the term "any interest or instrument commonly known as a security."

In sum, the court finds that the Interests in NSC constitute neither "stock," nor an "investment contract," nor "any interest or instrument commonly known as a security." The court will grant defendants' motion to dismiss Count I of Great Lakes' complaint.

C. Does the Court Have Jurisdiction Over Great Lakes' Remaining Claims?

Counts II through VIII of Great Lakes' complaint are based on alleged violations of state law and common law. Because the court will dismiss plaintiff's sole federal law claim, the court must dismiss plaintiffs' pendent state law claims for lack of jurisdiction. See *United Mine Workers of America v. Gibbs*, 383 U.S. 715, 726, 16 L. Ed. 2d 218, 86 S. Ct. 1130 (1966).

III. CONCLUSION

For the forgoing reasons, the court will grant defendants' motion to dismiss all counts of plaintiff's complaint. The court will issue an Order [****58**] in accordance with this Opinion.

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> Before the
 > Federal Communications Commission
 > Washington, D.C. 20554
 >
 > In re Application of)
 >)
 > BAKER CREEK COMMUNICATIONS, L.P.) File No. 0000000111
 >)
 > For Authority to Construct and Operate)
 > Local Multipoint Distribution Services In)
 > Multiple Basic Trading Areas)
 >)
 >)
 >
 >

> MEMORANDUM OPINION AND ORDER
 >

>
 > Adopted: September 22, 1998 Released: September 22, 1998
 >

> By the Chief, Public Safety and Private Wireless Division:
 >

I. INTRODUCTION

> 1. The Division has before it a Petition to Dismiss or Deny or in the
 > Alternative, to Institute an
 > Inquiry filed by NextBand Communications, L.L.C. (Nextband). In its Petition to
 > Deny, Nextband challenges the Local Multipoint Distribution Service (LMDS)
 > long-form application filed by Baker Creek Communications, L.P. (Baker Creek).
 > Baker Creek participated in the LMDS auction completed on March 25, 1998, as a
 > small business with a 45 percent bidding credit and was the high bidder for 232
 > licenses.

> 2. In its Petition to Deny, Nextband contends that Baker Creek is not
 > eligible for the bidding
 > credit it claimed under the Commission's LMDS Designated Entity (DE) rules.
 > Specifically, Nextband argues that Hyperion Telecommunications, Inc. (Hyperion),
 > and its controlling principal, Adelphia Communications Corp. (Adelphia), are
 > affiliates of Baker Creek and that their gross revenues must be taken into
 > account when determining Baker Creek's eligibility for bidding credits. If the
 > revenues of these entities are included when calculating Baker Creek's gross
 > revenues, it becomes ineligible for any bidding credit. In its pleadings, Baker
 > Creek contends that neither Hyperion nor Adelphia are affiliates and that its
 > arrangements with Hyperion comply with the DE rules. For the reasons that
 > follow, we find that Hyperion and Adelphia are affiliates of Baker Creek and, as
 > a result, Baker Creek is not eligible to receive the bidding credits it claimed
 > during the LMDS auction. We therefore grant Nextband's Petition to Deny to the
 > extent set forth below.

II. BACKGROUND

> 3. The Auction. On January 20, 1998, Baker Creek filed an FCC Form 175
 > to allow it to
 > participate in the Commission's LMDS auction, which was accepted for filing by
 > the Public Safety and Private Wireless Division (Division) on January 27, 1998.
 > The LMDS auction commenced on February 18, 1998. On March 9, 1998, the Wireless
 > Telecommunications Bureau (Bureau) received a letter requesting that it rule on
 > whether Baker Creek properly calculated its gross revenues when it applied for a
 > small business discount under the Commission's DE rules. Baker Creek opposed
 > this request. On March 25, the auction of 986 LMDS licenses was completed.
 > Baker Creek was the high bidder for 232 LMDS licenses. On March 27, 1998, the
 > Auctions and Industry Analysis Division rejected the letter request for an
 > inquiry that was received during the LMDS auction and instructed the complaining
 > party to file a petition to deny Baker Creek's application at the end of the
 > auction.

> 4. Post-Auction Filings. On April 16, 1998, the Division accepted Baker

> Creek's long-form
 > application for licenses to operate LMDS facilities in the BTAs where it was the
 > high bidder. On May 5, 1998, Baker Creek made a minor amendment to its
 > long-form application, reflecting a change in the contact person for Baker
 > Creek. On May 15, 1998, the Division requested additional information from
 > Baker Creek in relation to its long-form application. On May 18, 1998,
 > Nextband, through its attorneys, filed a Petition to Deny the grant of the
 > licenses Baker Creek had successfully bid for at auction. On May 21, 1998,
 > Baker Creek again amended its long-form application to change its point of
 > contact. Because of changes in its regulatory counsel, Baker Creek filed a
 > Motion for Extension of Time to allow it more time in which to file its
 > opposition to Nextband's Petition to Deny. The Division granted this motion on
 > June 2, 1998. Also on June 2, 1998, Baker Creek amended its long-form
 > application to include information requested by the Division in its letter of
 > May 15, 1998.

III. DISCUSSION

> 5. After careful review of the record in this proceeding, we agree with
 > Nextband and find that
 > Hyperion is an affiliate of Baker Creek. Therefore, Baker Creek is ineligible
 > for the bidding credit it claimed in its application. We therefore grant
 > Nextband's Petition to Deny to the extent that it seeks to disqualify Baker
 > Creek from obtaining a bidding credit and we grant Baker Creek's application
 > subject to the payment of the full gross amount of its bids in the LMDS auction.
 > The basis for this determination is set forth below.

> A. The Commission's Rules and Precedent.

> 6. The LMDS Designated Entity Rules. Under Section 101.1107 of the
 > Commission's Rules,
 > 47 C.F.R.

101.1107, a winning bidder in the LMDS auction that qualifies as a
 > very small business may use a bidding credit to lower the cost of its winning
 > bid by 45 percent. A very small business is defined as "an entity that,
 > together with its affiliates and controlling principals, has average gross
 > revenues for the three preceding years of not more than \$15 million." The
 > definition of affiliate contained in Section 101.1112(h)(1) of the Commission's
 > Rules, 47 C.F.R.

101.1112(h)(1), defines "affiliate" as any individual or
 > entity that: directly or indirectly controls or has the power to control the
 > applicant; is directly or indirectly controlled by the applicant; is directly or
 > indirectly controlled by a third person or parties who are also controlled or
 > have the power to control the applicant; or has an identity of interest with the
 > applicant. Control can be either positive or negative. Contrary to Baker
 > Creek's assertions, "it is immaterial whether it is exercised so long as the
 > power to control exists." This definition of control is intended to include
 > instances of both de facto and de jure control. Typically, de jure control is
 > evidenced by ownership of 50.1 percent or more of an entity's voting interest,
 > while de facto control is determined on a case-by-case basis after considering
 > all of the circumstances of a given application. The remaining subsections of

> Section 101.1112(h) establish objective criteria which give guidance for
 > determining whether a given entity exercises control over the applicant.

>
 > 7. Analytic Framework. The factors outlined in Section
 > 101.1112(h)(2)-(10) generally require
 > an inquiry into the potential for control arising from the existence of a given
 > factor. With the exception of subsections (3) and (4), these factors involve
 > question of de facto control and are determined on a case-by-case basis after
 > considering all of the relevant facts and circumstances of a given application.
 > The factors outlined in Section 101.1112(h)(2)-(10) are not the only ones to be
 > considered in the analysis of control. While there is no exact formula for
 > determining control, the analysis requires that we address the facts in light of
 > the six factors enumerated in Intermountain Microwave. The six Intermountain
 > Microwave factors are: (1) Who controls daily operations?; (2) Who is in charge
 > of employment, supervision, and dismissal of personnel?; (3) Does the licensee
 > have unfettered use of all facilities and equipment?; (4) Who is in charge of
 > the payment of financing obligations, including expenses arising out of
 > operating?; (5) Who receives monies and profits from the operation of the
 > facilities?; and (6) Who determines and carries out the policy decisions,
 > including preparing and filing applications with the Commission?

>
 > 8. Generally, if the Commission deviates from the Intermountain Microwave
 > factors in analyzing
 > the presence of de facto control, it must provide a reasoned explanation for
 > doing so. However, where the issue involves the control of an applicant for the
 > purpose of determining threshold eligibility to file an application as a DE,
 > rather than to operate an existing facility, there is often no record of conduct
 > relevant to several of the Intermountain Microwave factors. When applied in the
 > context of an application for an initial license at auction, the Intermountain
 > Microwave factors apply at the time the short-form application was filed and all
 > time thereafter. In these situations, the Commission has held that, in the
 > absence of a record of past conduct, the applicant's representations as to its
 > intention and related contractual provision are relevant, but the weight to be
 > ascribed to these representations must be evaluated in light of the entire
 > record. Furthermore, the Intermountain Microwave factors must be construed in
 > light of the current realities of the industry involved.

>
 > 9. Investment Protections. Investment protection provisions, which are
 > designed to protect a
 > minority shareholder's investment, do not automatically constitute the potential
 > to exercise control over an applicant. Permissible investment protections
 > typically give the minority shareholder a decision-making role, through
 > supermajority or similar mechanisms, in major corporate decisions that
 > fundamentally affect their interests. Such decisions may include: (1) issuance
 > or reclassification of stock; (2) setting compensation for senior management;
 > (3) expenditures that significantly affect market capitalization; (4) incurring
 > significant corporate debt or otherwise encumbering corporate assets; (5) sale
 > of major corporate assets; (6) fundamental changes in corporate structure.
 > Investment protection provisions may confer actual control upon the minority
 > owner where they give it the power to dominate the management of corporate
 > affairs. As with the Intermountain Microwave analysis, the analysis of whether

- > an investment protection provision grants the minority owner the power to
- > control is a fact-based inquiry with no precise formula for evaluating all
- > factors.
- >
- > B. Baker Creek's Long-form Application.
- >
- > 10. Organization of Baker Creek. In its amended long-form application
- > Baker Creek reveals that
- > it is a Delaware limited partnership composed of two partners: one general
- > partner, Baker Creek G.P. (Baker Creek G.P. or General Partner), and one limited
- > partner, Hyperion (Hyperion or Limited Partner). Baker Creek G.P. holds a 50.1
- > percent voting interest in Baker Creek which it received in exchange for a \$501
- > investment. Baker Creek G.P. is controlled by John C. Rigas. Hyperion holds
- > the remaining 49.9 percent voting interest in Baker Creek which it received in
- > exchange for a \$499 investment. Hyperion is controlled by Adelphia, which is
- > controlled by members of the John J. Rigas family. John J. Rigas is John C.
- > Rigas' uncle. In addition to the \$499 contribution for its voting interest,
- > Hyperion provided \$10,000,000 for Baker Creek's up-front payment for the LMDS
- > auction. Hyperion has also agreed to pay the entire cost of acquiring the
- > licenses won by Baker Creek in the LMDS auction -- a total capital commitment of
- > at least \$25,631,379. This investment is deemed a "Preferred Capital
- > Contribution" under the terms of the Partnership Agreement.
- >
- > 11. Management. The Partnership Agreement calls for the creation of a
- > Management Committee
- > which will make certain decisions for Baker Creek. The Management Committee
- > consists of three members, two designated by the General Partner and one
- > designated by the Limited Partner. Each member of the Management Committee is
- > entitled to one vote, with a majority ruling. The presence of two members of
- > the Committee, one representing each of the partners, is necessary for a quorum.
- > The Management Committee is to ratify Baker Creek's yearly budgets. Under the
- > Partnership Agreement the General Partner prepares a proposed budget for the
- > upcoming year and a business plan for the year covered by the budget and the
- > succeeding four years. The business plan must be agreed upon by both the
- > General Partner and the Limited Partner. Once the business plan is agreed upon,
- > the Limited Partner may propose changes to the budget and the General Partner
- > must make all proposed changes which are "reasonable." Once this process is
- > completed, the General Partner submits the budget to the Management Committee
- > for approval.
- >
- > 12. The General Partner is obliged to abide by the policies, strategies,
- > and standards established
- > by the Management Committee. The partnership agreement further sets out the
- > powers and duties of the General Partner. While these powers are fairly broad,
- > the Partnership Agreement also places some specific limits on the General
- > Partner's powers. Thus, it is easier to describe the powers of the General
- > Partner in terms of what it may not do rather than in terms of what it may.
- > Without the consent of the Limited Partner, neither the General Partner nor the
- > Management Committee may cause Baker Creek to:
- >
- > 1) sell any equity or convertible debt interest in the

- > Partnership; 2) incur indebtedness outside the yearly
- > budget; 3) incur indebtedness that is recourse to either
- > Partner; 4) act as a guarantor; 5) enter into any
- > transactions with the General Partner; 6) dispose of any
- > material property; 7) secure any indebtedness of the
- > Partnership by mortgage, pledge or lien on Partnership
- > property;
- > 8) acquire assets beyond the scope of the yearly business
- > plan;
- > 9) engage in any business other than LMDS;
- > 10) merge or consolidate with any other entity;
- > 11) redeem or purchase any equity interest in the Partnership;
- > 12) initiate or settle any litigation.
- >
- > 13. The Partnership Agreement further contemplates that the General
- > Partner will delegate "certain
- > responsibilities with respect to the day-to-day operation, management, and
- > supervision of the assets and business" to an affiliate of Hyperion pursuant to
- > a Service Agreement. Under the Service Agreement, Hyperion will: design,
- > build, manage and maintain the LMDS system, hire and train personnel, negotiate
- > contracts, provide continuing "advice" about marketing plans, assist in filings
- > before the FCC, maintain all accounts, billing and financial systems, and
- > represent the Partnership before all government authorities.
- >
- > 14. Distributions. The General Partner is paid compensation of \$100,000
- > annually "for services
- > rendered" to the Partnership. It is also entitled to distribution of profits in
- > proportion to its respective voting interest, but only after the Limited Partner
- > has been compensated for its capital contributions plus a preferred return.
- > Specifically, the Limited Partner is entitled to reimbursement for its
- > \$25,631,379 capital contribution plus a preferred return of between 35 and 45
- > percent, compounded quarterly, with the actual rate depending upon the ratio of
- > Partnership indebtedness to net capital contribution. In addition to these
- > disbursements, the Limited Partner, through an affiliate, receives compensation
- > from Baker Creek for services rendered under the service agreement. This
- > compensation is set at expenses incurred while providing the services plus an
- > additional 20 percent of that amount for profit.
- >
- > 15. Financing. The Partnership Agreement allows the General Partner to
- > request capital
- > contributions from the Limited Partner so long as the amount does not exceed the
- > amount specified in the approved annual budget. The Limited Partner has the
- > option of lending Baker Creek the amount requested at a rate of return of 35
- > percent per year, secured by a first priority security interest on all of Baker
- > Creek's assets. Finally, the Limited Partner has the right of first refusal on
- > all loans which Baker Creek solicits from third party lenders.
- >
- > C. Analysis Under Intermountain.
- >
- > 16. Control of Daily Operation. First, under the "control of daily
- > operations" factor, Nextband

> has raised concerns about the service agreement contemplated in Baker Creek's
 > Partnership Agreement. By its terms, the Service Agreement gives Hyperion the
 > authority to manage Baker Creek's marketing, filings, record keeping,
 > representation before the government, contract negotiations, employment
 > decisions, system maintenance, engineering, design, and operation. Baker Creek
 > argues that its arrangements under the Service Agreement are permissible under
 > Commission precedent. We agree with Baker Creek that "turn-key" service
 > agreements are permissible under the DE rules so long as they do not shift
 > control to the managing entity. However, we disagree with Baker Creek's analysis
 > of our precedent addressing this issue. The Intermountain Microwave factors
 > must be applied to the entire set of circumstances involving an application, not
 > only to the facts of the service agreement in isolation.

>
 > 17. Bearing this in mind, we find that the circumstances presented here
 > differ significantly from
 > those found permissible in the precedent relied upon by Baker Creek.
 > Specifically, Baker Creek relies heavily upon Ellis Thompson to support its
 > assertion that its Service Agreement does not impermissibly shift control to
 > Hyperion. In Ellis Thompson the Commission reasoned that the licensee was
 > intimately involved in setting the parameters of performance and in reviewing
 > the managers achievement of goals set by the licensee -- Ellis Thompson. This
 > does not appear to be the case here. Baker Creek's Partnership Agreement
 > provides Hyperion with the authority to manage "day to day operations conducted
 > in accordance with Baker Creek's business plan." As discussed below, Baker
 > Creek is not fully in control of the business plan or budget of Baker Creek. As
 > a result, the General Partner does not have the same control over the budget
 > allocated to the system manager as that found permissible in Ellis Thompson.
 > Thus, it appears that Hyperion is to manage the day-to-day operations of Baker
 > Creek in accordance with the business plan ultimately authorized by Hyperion
 > itself.

>
 > 18. In addition, given the totality of the circumstances of the
 > relationship between Baker Creek
 > and Hyperion, Baker Creek's right to terminate the Service Agreement for cause
 > does not provide us with the same measure of assurance of control over the
 > managing agent as that found in Ellis Thompson. In its role as Limited Partner,
 > Hyperion has the power to control Baker Creek's business plan and budget. The
 > Service Agreement simply requires Hyperion to use "reasonable commercial
 > efforts" when managing the LMDS system. Under this standard, so long as
 > Hyperion is using reasonable efforts to execute the day-to-day operations, and
 > barring unconscionable or unlawful conduct, it is unlikely that Baker Creek
 > will have grounds to terminate the management agreement for cause. In fact,
 > under the terms of the Service Agreement, Baker Creek is obligated to cooperate
 > with Hyperion in its endeavors within the scope of the business plan. As a
 > result, we find that the provision giving Baker Creek the right to terminate the
 > Service Agreement for cause does not shift the balance of control in Baker
 > Creek's favor. Therefore, because Hyperion plays a dominant role in
 > establishing the budget governing the outlays to itself in its role as managing
 > agent, we find that the Service Agreement will grant Hyperion an impermissible
 > level of control over the daily operations of Baker Creek contrary to the
 > Commission's DE rules.

- >
- > 19. Control of Employment Decisions. Under Baker Creek's Partnership Agreement, the General
- > Partner has the authority to make employment decisions for the Partnership and
- > Hyperion has the authority to assist Baker Creek in these personnel matters. We
- > agree with Baker Creek that this arrangement does not, in as much as it relates
- > to the lower level staff employed to construct and operate the system, shift
- > control to Hyperion contrary to the Commission's rules. However, we do not
- > agree with Baker Creek's assertion that the General Partner's duty to "consult"
- > with the Limited Partner prior to the hiring or termination of Baker Creek's
- > chief executive officer, chief financial officer, chief marketing officer, or
- > chief technical officer has no bearing on the issue of de facto control. While
- > this provision may be a common investment protection legitimately used by
- > non-controlling passive investors, under the facts presented here this provision
- > has the effect of giving Hyperion additional leverage which it may use to
- > dominate the affairs of Baker Creek. Hyperion has the means to exert pressure on
- > the General Partner if it makes choices contrary to Hyperion's wishes. It has
- > veto power over Baker Creek's business plan and budget, controls the amount of
- > capital available for Baker Creek's use, and has the ability to determine the
- > amount of compensation the General Partner receives in exchange for its 50.1
- > percent interest in Baker Creek. Thus, while this requirement alone does not
- > shift control away from Baker Creek, in conjunction with the other circumstances
- > presented here, it indicates that Hyperion has potential control over Baker
- > Creek's appointment of officers.
- >
- > 20. Finally, we also note that the fact that the General Partner does not
- > have the power to
- > determine his own salary is relevant to the question of control over employment
- > decisions. The General Partner's annual compensation is established in the
- > Partnership agreement and the funds to pay it come ultimately from Hyperion.
- > Thus, under the Partnership Agreement the General Partner does not have the
- > power to alter its own compensation and appears more like a salary than
- > compensation for ownership. As such, this provision provides yet another
- > indication that Hyperion exerts control over Baker Creek.
- >
- > 21. Unfettered Access to Facilities and Equipment. The record indicates
- > that Baker Creek and
- > Hyperion share common facilities. Specifically, Baker Creek and Hyperion share
- > common business offices, and Baker Creek availed itself of Hyperion's bidding
- > facilities. In addition, the record reveals that the partners contemplate the
- > future sharing of Baker Creek's LMDS system facilities with Hyperion. Baker
- > Creek argues that despite these shared facilities there has been no showing as
- > required by Section 101.1112(h)(8), that this present or future sharing allows
- > Hyperion to control Baker Creek. We disagree. The Commission has ruled that
- > unfettered access to a facility is found where the applicant or licensee is the
- > owner or primary lessee of a given site. Here there are currently no facilities
- > of record other than Baker Creek's offices which are located within Hyperion and
- > Adelphia's joint places of business. Because Baker Creek's access to these
- > offices is derived from Hyperion and Adelphia's rights as owners or primary
- > lessees of the property, Baker Creek does not have unfettered access to these
- > facilities.

- >
- > 22. Regarding the possibility that Baker Creek and Hyperion may share
- > system facilities in the
- > future, we agree with Baker Creek that this eventuality is too speculative at
- > present to support conclusions about whether these arrangements will ultimately
- > give Hyperion control over Baker Creek at some future point. In this situation
- > it is unclear whether the integration of Baker Creek's LMDS facilities with
- > Hyperion's CLEC operation will require the LMDS operators to surrender
- > operational control of the systems when it shares switches. For example, it is
- > unclear whether Baker Creek's LMDS facility would be able to operate
- > independently without its interconnections with Hyperion as was the case in
- > Ellis Thompson. Furthermore, it also remains unclear whether Baker Creek would
- > be run in the future as its own wholly independent business to the same extent
- > as the cellular business at issue in Ellis Thompson. We therefore do not
- > consider the potential future sharing of facilities in our analysis of the
- > totality of the circumstances in the instant case.
- >
- > 23. Responsibility for Financial Obligations. Hyperion is the source of
- > all but a negligible
- > amount of Baker Creek's capital. Hyperion made available the \$10,000,000 Baker
- > Creek used as its up-front payment and is committed to providing at least
- > \$25,631,379 as payment for Baker Creek's total net bid in the LMDS auction.
- > Furthermore, the Partnership Agreement contains provisions which allow the
- > Limited Partner to control both the amount of capital Baker Creek may acquire
- > and the sources of capital available to it. The Limited Partner's power derives
- > from Section 4.3(b) of the Partnership Agreement, which requires that the
- > Limited Partner approve Baker Creek's business plan and budget. The budget
- > establishes the maximum amount of capital the General Partner may request from
- > the Limited Partner under Section 3.1(a). Section 4.4(d)(2) then forbids the
- > General Partner from incurring any debt outside the contemplation of the
- > business plan. Thus, because the Limited Partner has approval power over Baker
- > Creek's business plan and budget, it also has the power to determine the amount
- > of capital required by Baker Creek.
- >
- > 24. Regarding determining the source of Baker Creek's funding, while the
- > General Partner may
- > seek funding from an outside source, its ability to do so is restricted by
- > Section 4.4(d)(7) of the Partnership Agreement which denies the General Partner
- > the right to secure loans with partnership property. In addition to this
- > restriction, Section 3.2(c) grants the Limited Partner a right of first refusal
- > with regard to loans sought from outside parties. These two provisions will
- > have the effect of deterring potential outside lenders in the first instance and
- > giving the Limited Partner control of whether Baker Creek receives funds from
- > outside sources should an outside source of capital be located. These
- > provisions go beyond permissible investment protections because, when viewed
- > with the other factors present in the Partnership Agreement, they have the
- > effect of giving Hyperion the power to dominate Baker Creek's business affairs.
- >
- >
- > 25. We find that the limitations placed on Baker Creek's ability to raise
- > capital from sources other

> than Hyperion, and Hyperion's control over the amount of capital sought by Baker
 > Creek, renders Hyperion ultimately responsible for Baker Creek's financial
 > obligations. We disagree with Baker Creek's argument that, because the funds
 > are processed through Baker Creek's bank accounts, there is no indicia of
 > control. The central inquiry here involves an analysis of who is ultimately
 > responsible for providing the money to pay for the applicant's commitments.
 > Here, Hyperion has already committed to providing at least \$25,631,379 for use
 > by Baker Creek in meeting its financial obligations. In addition to this,
 > Hyperion also has the right to determine the amount and source of Baker Creek's
 > future commitments. Thus, it appears that the ultimate responsibility for Baker
 > Creek's financial status lies with Hyperion.

>
 > 26. Receipt of Monies and Profits. Baker Creek's Partnership Agreement
 > creates a system of
 > disbursement which favors the Limited Partner. We agree with Baker Creek that
 > the high risk of this venture may justify a preferred return. However, we
 > believe that the disbursement arrangements in place here go beyond mere
 > compensation for high risk and instead give Hyperion control over the amount of
 > return the General Partner will receive. Under the Partnership Agreement, Baker
 > Creek is to distribute monies and profits in the following priority. First, the
 > General Partner receives a "fee" of \$100,000 per year for ten years. Then, the
 > Limited Partner is reimbursed for any loans plus interest of up to 35 percent.
 > Next, the Limited Partner receives a preferred return of between 35 percent and
 > 45 percent on its capital contributions. After Hyperion is reimbursed for its
 > preferred return, it receives all distributions Baker Creek issues until its
 > capital contributions have been repaid. Only after these prior obligations are
 > paid in full may the General Partner receive a 50.1 percent share of the
 > disbursements. The Partnership Agreement provides Hyperion with considerable
 > flexibility in determining the balances maintained in each of the accounts which
 > need to be satisfied before the General Partner receives any distributions. For
 > example, Baker Creek's business plan and budget are contingent upon Hyperion's
 > approval. This in turn establishes the parameters for determining the amount of
 > capital which Hyperion will be called upon to inject into the business.
 > Hyperion further has the option of deciding whether it wants to inject the
 > capital into the company in the form of a loan. Because of these arrangements,
 > we believe that Hyperion has the power to manipulate the return received by the
 > General Partner.

>
 > 27. In addition to the monies Hyperion receives under the disbursement
 > provisions of the
 > Partnership Agreement, it also receives compensation for its services provided
 > as Baker Creek's managing agent. As with its role in determining disbursements,
 > Hyperion's control over the business plan and budget gives it the power to
 > dictate the amount of its own compensation under the Service Agreement. By
 > having approval power over the business plan Hyperion is able to also establish
 > the scope and speed of the build-out of Baker Creek's LMDS systems in its 232
 > markets. This in turn establishes the costs incurred and reimbursed with a 20
 > percent profit to the managing agent -- Hyperion. In sum, we find that the
 > Limited Partner is in control of whether or not the General Partner receives a
 > return in proportion to its ownership of Baker Creek. This is contrary to the
 > proposition that the General Partner is in control of Baker Creek.

- >
- > 28. Control of Policy Decisions. Baker Creek's stated business purpose is
- > to develop an LMDS
- > system for use as "last-mile" wireless links. As described by Baker Creek, the
- > term "last-mile" refers to "the last link to connect a customer once Hyperion's
- > facilities move out of the public or other rights-of-way" The Partners
- > anticipate that Baker Creek will develop its LMDS system to provide a wireless
- > connection between Hyperion's fiber network and local end users of Hyperion's
- > competitive local exchange carrier services. Baker Creek is not authorized to
- > pursue other lines of business even though other potential uses for the spectrum
- > exist. This purpose was adopted because Baker Creek was created to complement
- > Hyperion's networks. Thus, the range of business options open to Baker Creek is
- > limited by the very purpose of the partnership. While this is certainly
- > permissible, it is also relevant when analyzing who has control over Baker
- > Creek's policy decisions because it indicates that, to some extent, the policy
- > decisions regarding the direction of the business venture have been
- > predetermined and are no longer within the control of the General Partner.
- >
- > 29. Furthermore, the structure established in the Partnership Agreement
- > places the final authority
- > over a wide range of policy decisions in the hands of Hyperion. Under Section
- > 4.3 of the Partnership Agreement, the Limited Partner is given the authority to
- > approve or disapprove of Baker Creek's business plan. The General Partner is
- > then responsible for preparing and submitting a budget to the Limited Partner.
- > This budget must be in compliance with the business plan. The Limited Partner
- > is then entitled to make any reasonable changes to the budget, provided they are
- > within the scope of the business plan. As discussed above, this control over
- > the business plan and budget allows Hyperion to establish the parameters for
- > borrowing and outlays. This, in turn, gives Hyperion the final say over the
- > speed and scope of system development and operation. It also gives Hyperion
- > control over disbursements to the General Partner. While it may be true, as
- > Baker Creek argues, that the Limited Partner's power to approve the business
- > plan is a prudent investment protection, that does not mean that it does not
- > also confer control upon the Limited Partner. The ability to determine the
- > business plan is not one of the typically permissible investment protections.
- > Rather, the power to control the business plan conveys to Hyperion the power to
- > dominate Baker Creek's business affairs by determining its policies and
- > operations.
- >
- > 30. The fact that the General Partner controls the Management Committee is
- > not sufficient to
- > override the control vested in the Limited Partner by the Partnership Agreement.
- > As discussed above, the Management Committee consists of three members, two
- > designated by the General Partner and one designated by the Limited Partner.
- > Each member of the Management Committee is entitled to one vote, with a majority
- > ruling. One of the main powers of the Management Committee is the power to
- > ratify Baker Creek's yearly budgets. However, the Management Committee does not
- > have the power to control either the business plan or budget processes. First,
- > policy decisions regarding the business plan and budget are made by the General
- > Partner and Limited Partner prior to the submission of the budget to the
- > Management Committee. The management committee only has the authority to

> approve the budget, it may neither alter the budget nor act in its absence.
 > Second, the members of the Management Committee are not likely to act contrary
 > to the direction of their appointing partners because that partner could remove
 > them for any reason. Third, if the General Partner were to direct the Management
 > Committee to veto a budget, this action by itself could not force a change in
 > the budget. Instead, the General Partner would have to resubmit the budget to
 > the Limited Partner. If the two partners could not agree on a budget, there is
 > nothing the Management Committee could do to reverse this. Instead, the General
 > Partner and Limited Partner would be forced to either negotiate an agreement on
 > the budget or cease the operation of the business. In such a negotiation, the
 > Limited Partner would have a distinct advantage because of its role as Baker
 > Creek's primary source of capital, its landlord, its potential client, and its
 > managing agent. Based on the facts before us, it appears that the purpose of
 > the partnership is limited from the outset to complement the Limited Partner's
 > existing business. In addition, the Limited Partner exercises direct control
 > over both the business plan and budget. Given all of these circumstances, we
 > find that the General Partner does not have control over Baker Creek's policy
 > decisions.

IV. CONCLUSION

> 31. We find that the record, when analyzed in light of the Commission's
 > LMDS Designated Entity
 > rules and the Intermountain Microwave criteria, supports Nextband's contention
 > that Hyperion Telecommunications, Inc., and Adelphia Communications Corp., exert
 > de facto control over of Baker Creek Communications, L.P. and should be treated
 > as its affiliates. The the structure of the relationship between Baker Creek
 > and Hyperion indicates that Hyperion dominates Baker Creek's affairs. Hyperion
 > controls, or has the power to control, Baker Creek's daily operations; its
 > access to its business facilities; its distribution of monies and profits; its
 > policy decisions; and is primarily responsible for Baker Creek's financial
 > obligations.

> 32. Because we find that Hyperion controls or has the power to control
 > Baker Creek, Hyperion
 > and its controlling principal, Adelphia, are both affiliates of Baker Creek as
 > defined by the LMDS designated entity rules. As a result, Hyperion and
 > Adelphia's gross revenues must be taken into account when calculating Baker
 > Creek's gross revenues for purposes of determining eligibility for bidding
 > credits. Hyperion and Adelphia's consolidated average gross revenues for the
 > three years ending March 31, 1998, are \$412,600,000. Thus, the gross revenues
 > of Baker Creek and its affiliates are more than \$75 million and, as a result,
 > Baker Creek is not eligible to receive any amount of a bidding credit. We
 > therefore grant Baker Creek's application for LMDS licenses but disallow its use
 > of the 45 percent bidding credit. Instead Baker Creek must pay the full amount
 > of its total gross high bid, \$46,602,533, rather than the total net high bid of
 > \$25,631,379.

> 33. Furthermore, Baker Creek must demonstrate that it meets the
 > eligibility criteria set out in

> Section 101.1003 of the Commission's rules, 47 C.F.R.

101.1003, with respect

> to its A block licenses. Because we conclude that Hyperion and Adelphia exert de
> facto control over Baker Creek, we find that Hyperion and Adelphia own an
> attributable interest in Baker Creek within the meaning of the Commission's LMDS
> eligibility rules. As a result, Baker Creek may not own an A block LMDS license
> which significantly overlaps any local exchange carrier (LEC) or cable company
> franchise service areas owned or controlled by either Adelphia or Hyperion. By
> this order we require that Baker Creek verify, graphically (e.g. using a map) or
> in a narrative, that there is no overlap between any affiliated cable/LEC
> service areas and its A block BTAs. If there is an overlap, we request that
> Baker Creek specify: (1) the geographic area of each attributable LEC or cable
> company franchise; and (2) the geographic area of each A block BTA won by the
> applicant; and (3) the percentage of the LMDS A block licensed service area
> which lies within the LEC/cable franchise area within ten (10) business days of
> the adoption of this order. If there is a significant overlap, then Baker Creek
> is responsible for divesting its interests in the LMDS A block license in
> accordance with the Commission's LMDS divestiture rules.

>

> 34. Finally, despite our conclusion that Baker Creek is ineligible for
> designated entity status, we
> nevertheless find that Baker Creek is qualified to be an LMDS licensee. In
> examining the effect of this Order on Baker Creek's fitness to be a licensee we
> concentrate on its truthfulness and reliability in dealing with the Commission.
> We must determine whether we can rely on Baker Creek to be forthright with the
> Commission in the future. Based on the record currently before us, we find no
> substantial evidence to indicate that Baker Creek has shown a lack of
> truthfulness or reliability in its dealings with the Commission. It appears
> that Baker Creek did not attempt to mislead the Commission about the
> relationship between itself, Hyperion and Adelphia in its application. Rather,
> the record indicates that Baker Creek fully disclosed its ownership structure
> and acted under the erroneous assumption that the structure comported with the
> requirements of the Commission's designated entity rules. Thus, while we have
> concluded that Baker Creek's ownership structure disqualifies it as a designated
> entity, the record does not suggest that Baker Creek will not deal truthfully or
> reliably with the Commission in the future. Therefore, we find that Baker
> Creek's non-conformity with our designated entity rules does not disqualify it
> from becoming an LMDS licensee. Notwithstanding, our action today is without
> prejudice to any possible future enforcement action relating to Baker Creek's
> non-conformity with the designated entity rules. As a result, we deny
> Nextband's Petition to Deny to the extent that it requests that the Commission
> deny Baker Creek's application outright, and grant Baker Creek's application
> subject to payment of its gross bid amount.

>

>

V. ORDERING CLAUSE

>

> 35. ACCORDINGLY, IT IS ORDERED that pursuant to Sections 4(i), 303(r), and
> 309

> of the Communications Act of 1934, as amended, 47 U.S.C.

154(i), 303(r), and

> 309, and Section 101.1110 of the Commission's Rules, 47 C.F.R.

101.1110

> (1997), the Petition to Deny the Application of Baker Creek Communications,
> L.P., IS GRANTED IN PART AND DENIED IN PART to the extent set out above.

>

> 36. IT IS FURTHER ORDERED that Baker Creek Communications, L.P.'s

> application

> is CONDITIONALLY GRANTED subject to the conditions and procedures set forth in

> the Public Notice Announcing the Conditional Grant of 265 Local Multipoint

> Distribution Service Licenses, DA 98-1748, released September 22, 1998.

>

> 37. IT IS FURTHER ORDERED that Baker Creek Communications, L.P.'s A Block

> LMDS licenses are GRANTED on the further condition that it demonstrate, as

> described above, its compliance with the Commission's eligibility rules, 47

> C.F.R.

101.1003.

>

> 38. IT IS FURTHER ORDERED that Baker Creek Communications, L.P.'s Motion

> for

> Leave to File Surreply is DENIED pursuant to Sections 1.45(c) and 101.43(b), 47

> C.F.R.

1.45(c), 101.43(b).

>

> 39. This action is taken under delegated authority pursuant to Sections

> 0.131 and 0.331

> of the Commission's Rules, 47 C.F.R.

0.131, 0.331.

>

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>

FEDERAL COMMUNICATIONS COMMISSION

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>

> D'wana R. Terry

> Chief, Public Safety and Private Wireless Division

> Wireless Telecommunications Bureau

Pktlaw@email.msn.com

From: <aherbst1@elp.rr.com>
To: <pktlaw@email.msn.com>
Sent: Friday, August 24, 2001 11:34 AM
Subject: Lots of USCS "FINANCIAL INSTRUMENT" From Lexis/Nexis
 From Lexis/Nexis

- > Documents 1 - 25 of 33.
- >
- > 1. 7 USCS § 2, (2001), TITLE 7. AGRICULTURE, CHAPTER 1. COMMODITY
- > EXCHANGES, § 2. Jurisdiction of Commission; liability of principal for act of
- > agent; Commodity Futures Trading Commission; transaction in interstate
- > commerce, UNITED STATES CODE SERVICE
- > ... delivery and in securities and financial instruments under the jurisdiction
- > of such agencies. (...
- > 2. 7 USCS § 13, (2001), TITLE 7. AGRICULTURE, CHAPTER 1. COMMODITY
- > EXCHANGES, § 13. Violations generally; punishment; costs of prosecution,
- > UNITED STATES CODE SERVICE
- > ... deposit, or a similar financial instrument if no nonpublic information is
- > ...
- > 3. 11 USCS § 548, (2001), TITLE 11. BANKRUPTCY, CHAPTER 5. CREDITORS, THE
- > DEBTOR, AND THE ESTATE, SUBCHAPTER III. THE ESTATE, § 548. Fraudulent
- > transfers and obligations, UNITED STATES CODE SERVICE
- > ... consists of-- (i) a financial instrument (as that term is defined in ...
- > 4. 12 USCS § 1843, (2001), TITLE 12. BANKS AND BANKING, CHAPTER 17. BANK
- > HOLDING COMPANIES, § 1843. Interests in nonbanking organizations, UNITED
- > STATES CODE SERVICE
- > ... options on futures that relate to financial instruments will be denied,
- > since ...
- > 5. 12 USCS § 3104, (2001), TITLE 12. BANKS AND BANKING, CHAPTER 32. FOREIGN
- > BANK PARTICIPATION IN DOMESTIC MARKETS, § 3104. Insurance of deposits,
- > UNITED STATES CODE SERVICE
- > ... connection with the issuance of a financial instrument by the branch for the
- > ...
- > 6. 14 USCS § 667, (2001), TITLE 14. COAST GUARD, PART I. REGULAR COAST
- > GUARD, CHAPTER 17. ADMINISTRATION, § 667. Vessel construction bonding
- > requirements, United States Code Service
- > ... completion bonds or other financial instruments from contractors for
- > construction, ...
- > 7. 15 USCS § 77b, (2001), TITLE 15. COMMERCE AND TRADE, CHAPTER 2A.
- > SECURITIES AND TRUST INDENTURES, DOMESTIC SECURITIES, § 77b. Definitions,
- > UNITED STATES CODE SERVICE
- > ... F Supp 647. Financial instrument which is nonexistent may still be " ...
- > 85 OGR 608. If financial instrument is properly denominated "fractional ...
- > 8. 15 USCS § 78c, (2001), TITLE 15. COMMERCE AND TRADE, CHAPTER 2B.
- > SECURITIES EXCHANGES, § 78c. Definitions and application, UNITED STATES CODE
- > SERVICE
- > ... Rep P 97278. Financial instrument which is nonexistent may still be " ...
- > 9. 16 USCS § 396f, (2001), TITLE 16. CONSERVATION, CHAPTER 1. NATIONAL
- > PARKS, MILITARY PARKS, MONUMENTS, AND SEASHORES, KALOKO-HONOKOHAU

8/28/01

NATIONAL

- > HISTORICAL PARK, § 396f. Acquisition of private lands; creation of surplus
- > property accounts; transfer and sale of accounts, UNITED STATES CODE SERVICE
- > ... Resolution Trust Corporation, such as financial instruments, notes, loans,
- > and bonds), or ...
- > 10. 18 USCS § 371, (2001), TITLE 18. CRIMES AND CRIMINAL PROCEDURE, PART I.
- > CRIMES, CHAPTER 19. CONSPIRACY, THE CASE NOTES SEGMENT OF THIS DOCUMENT HAS
- > BEEN SPLIT INTO 2 DOCUMENTS. THIS IS PART 1. USE THE BROWSE FEATURE TO REVIEW
- > THE OTHER PART(S)., § 371. Conspiracy to commit offense or to defraud United
- > States, UNITED STATES CODE SERVICE
- > ... through sale of false financial instruments, and then to launder proceeds of
- > fraud, where ...
- > 11. 18 USCS § 514, (2001), TITLE 18. CRIMES AND CRIMINAL PROCEDURE, PART I.
- > CRIMES, CHAPTER 25. COUNTERFEITING AND FORGERY, § 514. Fictitious
- > obligations, UNITED STATES CODE SERVICE
- > ... actual security or other financial instrument issued under the authority of
- > the ...
- > 12. 18 USCS § 2311, (2001), TITLE 18. CRIMES AND CRIMINAL PROCEDURE, PART
- > I. CRIMES, CHAPTER 113. STOLEN PROPERTY, § 2311. Definitions, UNITED STATES
- > CODE SERVICE
- > ... securities" to encompass variety of financial instruments, including bonds
- > and any forged, ...
- > 13. 18 USCS § 2314, (2001), TITLE 18. CRIMES AND CRIMINAL PROCEDURE, PART
- > I. CRIMES, CHAPTER 113. STOLEN PROPERTY, § 2314. Transportation of stolen
- > goods, securities, moneys, fraudulent State tax stamps, or articles used in
- > counterfeiting, UNITED STATES CODE SERVICE
- > ... securities" to encompass variety of financial instruments, including bonds
- > and any forged, ...
- > 14. 18 USCS Appx § 2F1.1, (2001), TITLE 18. CRIMES AND CRIMINAL PROCEDURE,
- > SENTENCING GUIDELINES FOR THE UNITED STATES COURTS. 18 USCS
- APPENDIX, CHAPTER
- > TWO. OFFENSE CONDUCT, PART F. OFFENSES INVOLVING FRAUD OR DECEIT, §
- 2F1.1.
- > Fraud and Deceit; Forgery; Offenses Involving Altered or Counterfeit
- > Instruments Other than Counterfeit Bearer Obligations of the United States,
- > UNITED STATES CODE SERVICE
- > ... Face values of fraudulent financial instruments known as "comptroller
- > warrants" that were ... connection with attempt to sell financial
- > instruments allegedly issued by ...
- > 15. 18 USCS Appx § 3B1.1, (2001), TITLE 18. CRIMES AND CRIMINAL PROCEDURE,
- > SENTENCING GUIDELINES FOR THE UNITED STATES COURTS. 18 USCS
- APPENDIX, CHAPTER
- > THREE. ADJUSTMENTS, PART B. ROLE IN THE OFFENSE, § 3B1.1. Aggravating Role,
- > UNITED STATES CODE SERVICE
- > ... defendant gave false financial instruments known as "comptroller warrants"
- > was ...
- > 16. 18 USCS Appx § 5E1.2, (2001), TITLE 18. CRIMES AND CRIMINAL PROCEDURE,
- > SENTENCING GUIDELINES FOR THE UNITED STATES COURTS. 18 USCS

APPENDIX, CHAPTER

> FIVE. DETERMINING THE SENTENCE, PART E. RESTITUTION, FINES, ASSESSMENTS,

> FORFEITURES, § 5E1.2. Fines for Individual Defendants, UNITED STATES CODE SERVICE

> ... involving money laundering of financial instruments; 18 U.S.C. § ...

> 17. 22 USCS § 1621, (2001), TITLE 22. FOREIGN RELATIONS AND INTERCOURSE,

> CHAPTER 21. SETTLEMENT OF INTERNATIONAL CLAIMS, GENERAL PROVISIONS, § 1621.

> Definitions, UNITED STATES CODE SERVICE

> ... States; "(D) domestic financial instruments purchased before May ...

> 18. 22 USCS § 2193, (2001), TITLE 22. FOREIGN RELATIONS AND INTERCOURSE,

> CHAPTER 32. FOREIGN ASSISTANCE, INTERNATIONAL DEVELOPMENT, OTHER PROGRAMS,

> OVERSEAS PRIVATE INVESTMENT CORPORATION, § 2193. Organization and management,

> UNITED STATES CODE SERVICE

> ... implementing policies, programs, and financial instruments with respect to

> sub-Saharan ...

> 19. 22 USCS § 2715c, (2001), TITLE 22. FOREIGN RELATIONS AND INTERCOURSE,

> CHAPTER 38. DEPARTMENT OF STATE, § 2715c. Conservation and disposition of

> estates, UNITED STATES CODE SERVICE

> ... proceeds of any sales, together with all financial instruments (including

> bonds, shares of ...

> 20. 22 USCS § 5421, (2001), TITLE 22. FOREIGN RELATIONS AND INTERCOURSE,

> CHAPTER 63. SUPPORT FOR EAST EUROPEAN DEMOCRACY (SEED), PRIVATE SECTOR

> DEVELOPMENT, § 5421. Enterprise funds for Poland and Hungary, UNITED STATES

> CODE SERVICE

> ... investors of such capital. (j) Financial instruments for individual

> investment ... possible efforts to establish financial instruments that will

> enable individuals to ...

> 21. 26 USCS § 475, (2001), TITLE 26. INTERNAL REVENUE CODE, SUBTITLE A.

> INCOME TAXES, CHAPTER 1. NORMAL TAXES AND SURTAXES, SUBCHAPTER E. ACCOUNTING

> PERIODS AND METHODS OF ACCOUNTING, PART II. METHODS OF ACCOUNTING, SUBPART

> D. INVENTORIES, § 475. Mark to market accounting method for dealers in

> securities., UNITED STATES CODE SERVICE

> ... in, or a derivative financial instrument in, any security described ...

> short position, and any similar financial instrument in such a security or ...

> 22. 26 USCS § 731, (2001), TITLE 26. INTERNAL REVENUE CODE, SUBTITLE A.

> INCOME TAXES, CHAPTER 1. NORMAL TAXES AND SURTAXES, SUBCHAPTER K. PARTNERS

> AND PARTNERSHIPS, PART II. CONTRIBUTIONS, DISTRIBUTIONS, AND TRANSFERS,

> SUBPART B. DISTRIBUTIONS BY A PARTNERSHIP, § 731. Extent of recognition of

> gain or loss on distribution., UNITED STATES CODE SERVICE

> ... marketable securities" means financial instruments and foreign currencies

> which are, as of the date of the ... 1940) of which it is the issuer, (ii)

> any financial instrument which, pursuant to its terms or any other ...

- > marketable securities, (iii) any financial instrument the value of which is
- > determined substantially ... money, or both. (C) Financial instrument. The
- > term "financial instrument" includes stocks and other ... interests in or
- > derivative financial instruments (including options, forward or ... short
- > positions, and similar financial instruments) in any asset described ...
- > 23. 26 USCS § 856, (2001), TITLE 26. INTERNAL REVENUE CODE, SUBTITLE A.
- > INCOME TAXES, CHAPTER 1. NORMAL TAXES AND SURTAXES, SUBCHAPTER M.
- REGULATED
- > INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS, PART II.
- REAL ESTATE
- > INVESTMENT TRUSTS, § 856. Definition of real estate investment trust.,
- > UNITED STATES CODE SERVICE
- > ... rate agreement, or any similar financial instrument, entered into by the
- > trust ...
- > 24. 26 USCS § 892, (2001), TITLE 26. INTERNAL REVENUE CODE, SUBTITLE A.
- > INCOME TAXES, CHAPTER 1. NORMAL TAXES AND SURTAXES, SUBCHAPTER N.
- TAX BASED
- > ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES, PART II.
- > NONRESIDENT ALIENS AND FOREIGN CORPORATIONS, SUBPART D.
- MISCELLANEOUS
- > PROVISIONS, § 892. Income of foreign governments and of international
- > organizations., UNITED STATES CODE SERVICE
- > ... foreign governments, or (ii) financial instruments held in the execution of
- > ...
- > 25. 26 USCS § 954, (2001), TITLE 26. INTERNAL REVENUE CODE, SUBTITLE A.
- > INCOME TAXES, CHAPTER 1. NORMAL TAXES AND SURTAXES, SUBCHAPTER N.
- TAX BASED
- > ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES, PART III.
- INCOME
- > FROM SOURCES WITHOUT THE UNITED STATES, SUBPART F. CONTROLLED
- FOREIGN
- > CORPORATIONS, § 954. Foreign base company income., UNITED STATES CODE
- > SERVICE
- > ... option contracts, or similar financial instruments (including notional
- > principal ... option contracts, or similar financial instruments (including
- > notional principal ...
- >
- >
- > 26. 26 USCS § 988, (2001), TITLE 26. INTERNAL REVENUE CODE, SUBTITLE A.
- > INCOME TAXES, CHAPTER 1. NORMAL TAXES AND SURTAXES, SUBCHAPTER N.
- TAX BASED
- > ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES, PART III.
- INCOME
- > FROM SOURCES WITHOUT THE UNITED STATES, SUBPART J. FOREIGN
- CURRENCY
- > TRANSACTIONS, § 988. Treatment of certain foreign currency transactions.,
- > UNITED STATES CODE SERVICE
- > ... contract, option, or similar financial instrument. The Secretary may
- > prescribe ... contract, option, or similar financial instrument if such
- > instrument is not marked to ...

- > 27. 26 USCS § 1221, (2001), TITLE 26. INTERNAL REVENUE CODE, SUBTITLE A.
- > INCOME TAXES, CHAPTER 1. NORMAL TAXES AND SURTAXES, SUBCHAPTER P. CAPITAL
- > GAINS AND LOSSES, PART III. GENERAL RULES FOR DETERMINING CAPITAL GAINS AND
- > LOSSES, § 1221. Capital asset defined., UNITED STATES CODE SERVICE
- > ... 6) any commodities derivative financial instrument held by a ...
- > ... 1) Commodities derivative financial instruments. For purposes of subsection
- > (... in commodities derivative financial instruments with customers in the
- > ordinary ... B) Commodities derivative financial instrument. (i) In general.
- > The term "commodities derivative financial instrument" means any contract or
- > financial instrument with respect to commodities (other than ...
- > 28. 26 USCS § 1382, (2001), TITLE 26. INTERNAL REVENUE CODE, SUBTITLE A.
- > INCOME TAXES, CHAPTER 1. NORMAL TAXES AND SURTAXES, SUBCHAPTER T.
- > COOPERATIVES AND THEIR PATRONS, PART I. TAX TREATMENT OF
- > COOPERATIVES, §
- > 1382. Taxable income of cooperatives., UNITED STATES CODE SERVICE
- > ... operating funds in these financial instruments only adds to overall ...
- > 29. 28 USCS § 1257, (2001), TITLE 28. JUDICIARY AND JUDICIAL PROCEDURE,
- > PART IV. JURISDICTION AND VENUE, CHAPTER 81. SUPREME COURT, § 1257.
- > State
- > courts; certiorari, UNITED STATES CODE SERVICE
- > ... question of whether privately issued financial instruments backed by wholly
- > ...
- > 30. 31 USCS § 3124, (2001), TITLE 31. MONEY AND FINANCE, SUBTITLE III.
- > FINANCIAL MANAGEMENT, CHAPTER 31. PUBLIC DEBT, SUBCHAPTER II.
- > ADMINISTRATIVE, § 3124. Exemption from taxation, United States Code Service
- > ... though mortgage-backed financial instruments commonly known as "Ginnie ...
- > 31. 39 USCS § 3626, (2001), TITLE 39. POSTAL SERVICE, PART IV. MAIL MATTER,
- > CHAPTER 36. POSTAL RATES, CLASSES, AND SERVICES, SUBCHAPTER II.
- > PERMANENT
- > RATES AND CLASSES OF MAIL, § 3626. Reduced rates, UNITED STATES CODE
- > SERVICE
- >
- > ... charge card, or similar financial instrument or account, provided by or ...
- >
- > 32. 42 USCS § 1786, (2001), TITLE 42. THE PUBLIC HEALTH AND WELFARE,
- > CHAPTER 13A. CHILD NUTRITION, § 1786. Special supplemental nutrition program
- > for women, infants, and children, UNITED STATES CODE SERVICE
- > ... voucher, or other negotiable financial instrument by which benefits under
- > this ...
- > 33. 43 USCS § 1611, (2001), TITLE 43. PUBLIC LANDS, CHAPTER 33. ALASKA
- > NATIVE CLAIMS SETTLEMENT, § 1611. Native land selections, UNITED STATES CODE
- > SERVICE
- > ... Resolution Trust Corporation, such as financial instruments, notes, loans,
- > and bonds), or ...